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Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax

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EXEMPT ORGANIZATIONS: A STUDY OF THEIR NATURE AND THE APPLICABILITY OF THE UNRELATED BUSINESS INCOME TAX

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I. INTRODUCTION

An exemption from federal income tax was traditionally granted to certain types of organizations (hereinafter called "exempt organizations" or "EOs")[1]. The exemptions were maintained so long as the EOs complied with relatively clear federal limits. If the limits were exceeded, EOs were taxed on a portion of their income via the unrelated business income tax ("UBIT") or, in more serious cases, sanctioned by the loss of their exempt status.

Recently, these exemptions and limits have become targets of tax "reform" and tax "simplification."[2] As a result, the previously well-defined limits for EOs are changing. Already there has been an adverse change in the law regarding charitable giving: the Tax Reform Act of 1986 reduced the

1. The term "exempt" will be used to describe these organizations instead of more traditional terms such as "nonprofit" or "not-for-profit." The difference is that "exempt" organizations are essentially created and defined by federal tax law while "nonprofit" or "not-for-profit" organizations are primarily governed by state law. *See, e.g.*, BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 1.1 (6th ed. 1992 & Supp. 1994).

2. Tax "reform" and "simplification" in this context began with President Carter whose proposals would have had the effect of reducing the number of taxpayers with a tax incentive for charitable giving. *See*, HOPKINS, *supra* note 1, § 4.1 at 53 (citing U.S. DEP'T OF TREASURY, THE PRESIDENT'S 1978 TAX PROGRAM, DETAILED DESCRIPTIONS AND SUPPORTING ANALYSES OF THE PROPOSALS 18 (Jan. 30, 1978)). The rational behind the reforms and simplifications are discussed infra part II.B.1.

incentive for donations by reducing the number of taxpayers eligible to obtain a charitable contribution deduction.[3]

More change is on the way. EOs are being scrutinized as untapped sources of federal tax revenue.[4] Even though the scrutiny has not yet caused a significant statutory change, the IRS is enhancing its enforcement efforts and the courts are reinterpreting case law, particularly in the area of the UBIT.[5] Formerly solid exemption limitations are becoming blurred.[6]

There is every indication that the trends toward decreased charitable contributions and increased tax collection will continue and will adversely affect EOs.[7] In this climate, EOs must be aware of their options to avoid the inadvertent loss of their exempt status and the unnecessary imposition of federal income tax.

With the hope of clarifying a difficult issue, this paper examines the traditional categories of EOs,[8] rationales for their exempt status,[9] tests for gaining and maintaining their exempt status,[10] standard tests used to impose UBIT,[11] and ways in which the traditional tests and standards are changing. Furthermore, this paper predicts areas of future change,[12] discusses ways in which EOs can immediately strengthen their exempt status to avoid unnecessary UBIT,[13] and suggests principled arguments which can be used to halt additional unwarranted incursions by tax "reformers" and "simplifiers."[14]

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3. The charitable deduction contribution is beyond the scope of this paper, except for minor references. *See, e.g., infra* part II.B.3.b. However, for more on this topic, see HOPKINS, *supra* note 1, § 4.1.

4. The most notable effort occurred in 1987 when Congressional hearings focused on allegedly competitive practices by tax-exempt organizations. *Unrelated Business Income Tax: Hearings before the Subcomm. on Oversight of the House Comm. on Ways and Means,* 100th Cong., 1st Sess. (June 22, 25, 26, 29 and 30, 1987) (Ways and Means Committee Print 100-30). As discussed by HOPKINS, *supra* note 1, § 4.1, at 56, the Subcommittee asked about EO's income-producing activities, the resulting revenue, the relationship between increases in income-producing activities and federal budget cuts, the efficacy of the unrelated business income tax rules, the adequacy of reporting for unrelated business income, and the adequacy of the IRS' enforcement program for EOs.

5. *See infra*, part III - IV.

6. *Id.*

7. *See* HOPKINS, *supra* note 1, §§ 38.1 - 38.4, particularly at 843.

8. *See infra*, part II.

9. *Id.*

10. *Id.*

11. *See infra,* part III.

12. *See infra*, part IV.

13. *See infra*, part VI.

14. *See infra*, part V.

II. EXEMPT ORGANIZATIONS

A. An Overview of Facts About EOs

1. Types of EOs

Most EOs are rigidly[15] defined in section 501(c)[16] of the Internal Revenue Code ("IRC").[17] They encompass more than America's well-known "charitable" organizations such as the United Way and the Salvation Army. They include America's churches, business leagues, social clubs and sports leagues; as well as some of America's most prominent schools and hospitals. EOs not only include organizations commanding wide public support, but also more controversial organizations such as the Ku Klux Klan and the Star Trek Fan Club.

2. Economic Power of EOs

EOs wield significant economic power. Some EOs are substantial and sophisticated in their own right. For example, in 1989, the American National Red Cross reported over $1.1 billion in revenue and Harvard University reported over $6.5 billion in assets.[18] The numbers are even more impressive when EOs are considered as a group. Each year EOs generate revenues exceeding $750 billion—roughly 15% of the nation's GNP.[19] Furthermore, total contributions to charity keep rising. Gifts to charitable organizations equaled $79.84 billion in 1985, $116.8 billion in 1991 and $124.3 billion for 1992.[20]

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15. Knights of Columbus Bldg. Ass'n of Stamford, Connecticut, Inc. v. United States, 88-1 U.S.T.C. (CCH) ¶ 9336 (D. Conn. Mar. 22, 1988) (§ 501(c) "generally consists of narrowly defined categories of exemption," which "are replete with rigid requirements" that "a putatively exempt organization must demonstrate it meets").

16. The Code states that "[a]n organization described in subsection (c) or (d) [of § 501] or section 401(a) shall be exempt from taxation . . . unless such exemption is denied under section 502 or 503." I.R.C. § 501 (1994).

17. Throughout this paper, the Internal Revenue Code of 1986 is cited only by its section ("§") number.

18. *See* James Cook, *Businessmen with Halos*, FORBES, Nov. 26, 1990, at 100, 106.

19. *Id. Cf.*, VIRGINIA ANN HODGKINSON AND MURRY S. WEITZMAN, DIMENSIONS OF THE INDEPENDENT SECTOR, (2d ed. 1986) [hereinafter Hodgkinson & Weitzman], cited by HOPKINS, *supra* note 1, § 1.7 (The "independent sector" (composed of §501(c)(3)-(4) entities) had a 5.6 percent share of total national income ($3.144 trillion) as contrasted with the for-profit sector's share of 79.3 percent and the government's share of 14.5 percent).

20. AMERICAN ASSOCIATION OF FUND RAISING COUNCIL, GIVING USA (New York, 1993) quoted in HOPKINS, *supra* note 1 at Supp. 3. *Cf.*, HOPKINS, *supra* note 1, § 1.7 beginning at 22 discussing Hodgkinson and Weitzman, *supra* note 19 which indicates that, in 1984, contributions were the source of 26.9 percent of the funds received by the independent sector. Other amounts were received from dues, fees and other charges (37.8 percent), government (26.9 percent) and other sources including investments (8.4 percent). HOPKINS, *supra* § 1.7.

B. Pros and Cons of EO Status

1. Theories Supporting the Existence of EO Status

Several theories (rather than a single unifying theory) support the existence of EOs.[21] These theories, including "tradition" and oft cited public and tax policies, are central to the existence of EOs.

a. Tradition

One rationale for exemption is pure "tradition." The federal income tax exemption for charitable and other organizations was implemented when the income tax originated in 1913.[22] The committee reports accompanying the 1913 act are largely silent on the reasons for initiating and continuing the exemption. It is often presumed Congress simply found that tax relief was warranted and explanations were unnecessary.[23] This presumption is probably accurate because tax exemptions for charitable organizations (from excise taxes, for example) were common long before 1913, particularly for religious organizations.[24]

b. EOs Lessen The Burdens Of Government

The most common rationale for exemption is a long-standing public policy to exempt from federal income tax those organizations which lessen the burdens of government. The U.S. Supreme Court stated early on that "the exemption is made in recognition of the benefit which the public derives from corporate activities of [EOs], and is intended to aid them when not conducted for private gain."[25] One of the rare early congressional reports further supports this public policy rationale:

> The exemption. . . is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.[26]

Without EOs, the government would have to perform additional services. In return for the services EOs provide, the government is willing to forego tax

21. *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 69 (1981); *See also* James J. McGovern, *The Exemption Provisions of Subchapter F*, 29 TAX LAW. 523 (1976).

22. Revenue Act of 1913, 38 Stat. 114, 66 (1913) (codified as amended in 26 U.S.C. (1994)).

23. *See, e.g.*, HOPKINS, *supra* note 1, § 1.3, at 8.

24. *See, e.g.*, Trustees of the First Methodist Episcopal Church v. City of Atlanta, 76 Ga. 181 (1886); SANFORD H. COBB, THE RISE OF RELIGIOUS LIBERTY IN AMERICA, 482-528 (1902).

25. Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas, 263 U.S. 578, 581 (1924).

26. HOPKINS, *supra* note 1, § 1.3 n.n.32, *citing* H.R. Rep. No. 1860, 75th Cong., 3d Sess. 49 (1939).

revenues it would otherwise receive.

c. Fostering Voluntarism and Pluralism

Also important to exempt status are the public policies to foster voluntarism and pluralism.[27] That is, society is thought to benefit from the dedication of private resources to the public good and from the fact that private resources can be more flexibly and efficiently devoted than governmental ones.[28] With regard to voluntarism, Norman Fink, during his tenure as Vice President for Development of Columbia University, stated:

> Voluntarism has been responsible for the creation and maintenance of churches, schools, colleges, universities, laboratories, hospitals, libraries, museums, and the performing arts; voluntarism has given rise to the private and public health and welfare systems and many other functions and services that are now an integral part of the American civilization. In no other country has private philanthropy become so vital a part of the national culture or so effective an instrument in prodding government to closer attention to social needs.[29]

With regard to pluralism, George P. Shultz, then-Secretary of the Treasury, stated in testimony before the House Committee on Ways and Means that: "[EOs] are an important influence for diversity and a bulwark against overreliance on big government."[30] Schultz was echoing an old theme set forth by John Stuart Mill in On Liberty (1859):

> Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments and endless diversity of experience. What the State can usefully do is to make itself a central repository, an active circulator and diffuser, of the experience resulting from many trials. Its business is to enable each experimentalist to benefit by the experiments of others; instead of tolerating no experiments but its own. [31]

The U.S. was founded on the notion that society need not and should not rely upon big government. The principles of voluntarism and pluralism are central to this notion.

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27. Green v. Connally, 330 F. Supp. 1150, 1162 (D.D.C. 1971), *aff'd sub nom.*, Coit v. Green, 404 U.S. 997 (1971).

28. Edward H. Rabin, *Charitable Trusts and Charitable Deductions,* 41 N.Y.U.L. REV. 912, 920-25 (1966).

29. Norman S. Fink, *Taxation and Philanthropy—a 1976 Perspective*, 3 J. COLL. & UNIV. L. 1, 6-7 (1975).

30 U.S. DEP'T OF THE TREASURY, PROPOSALS FOR TAX CHANGE, 72 (Apr. 30 1973).

31. Quoted in HOPKINS, *supra* note 1, § 1.6, at 20.

d. Tax Policy

Tax policy also justifies exemption from taxation.[32] Tax policy indicates that individuals should be allowed to associate to accomplish their goals more effectively. Since income is not generated by the association (money is simply pooled for spending purposes), income tax would be improper.

e. Political Process

Finally, it is important to acknowledge that the political process can create EOs without reference to the policies discussed above. For example, professional football leagues[33] were granted EO status as part of the legislation effecting the merger between the National Football League and the American Football League.[34] Similarly, university investment vehicles[35] were an outgrowth of Congress' effort to overturn an IRS ruling regarding a common investment fund.[36]

2. Criticisms of EOs

A number of criticisms are aimed at the tax exempt status of EOs. According to critics, they drain government resources, exploit tax loopholes, and force others to shoulder the burden of an increasing demand for governmental programs.[37]

Other criticisms are aimed at the charitable deduction contribution. The major complaint is that a taxpayer in a high tax bracket obtains a higher deduction for a charitable gift than one in a low tax bracket.[38]

A recent criticism focuses on the "commerciality" of successful EOs.[39] The EO's fund-raising activities are often the same activities undertaken by commercial businesses. Businesses complain that EOs compete against them unfairly because EOs have a "halo" effect, no start-up costs, a ready-made market, and the ability to undercut the commercial competition because they pay no income tax.[40] Businesses argue that EOs receiving the benefit of com-

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32. *See, e.g*, McGlotten v. Connally, 338 F. Supp. 448, 458 (D.D.C. 1972).

33. I.R.C. § 501(c)(6) (1994).

34. HOPKINS, *supra* note 1, § 1.6, at 19-20.

35. I.R.C. § 501(f) (1994).

36. HOPKINS, *supra* note 1, §1.6, at 20. *See also* George D. Webster, *Certain Inconsistencies and Discrimination in the Taxation of Exempt Organizations*, 21 J.TAX 102 (1964).

37. HOPKINS, *supra* note 1, § 3.1, at 40-41.

38. *Id.* §§ 3.1-3.3.

39. HOPKINS, *supra* note 1 , §§ 38.1-38.4, at 829.

40. *See, e.g.*, Statement by Rep. James D. Santini, Chairman, Business Coalition for Fair Competition issued to the Comm. on Small Business, Subcomm. on Procurement, Taxation and Tourism of the United States House of Representatives, *reprinted in* 94 TAX NOTES TODAY, 117-25, June 17, 1993.

mercial activities should also accept the responsibilities of commercial ventures at tax time.[41]

The "commerciality" argument was instrumental in the repeal of the exempt status for the Blue Cross and Blue Shield organizations. The chairman of the House Committee on Ways and Means working group for gathering information on the exemption repeal stated "[i]f they quack like a profit-making entity and waddle like a profit-making entity, they should be taxed like a profit-making entity."[42] The intricacies and implications of the commerciality doctrine are explored further in Section IV.

3. Advantages of EO Status

EO status has several advantages. Among other things, EOs are exempt from federal income tax, may qualify to offer income tax deductions to individual donors, and are targeted for donations from private foundations and state and federal agencies.

a. Federal Tax Relief

The most important advantage shared by all EOs is the exemption from federal income tax.[43] Additional tax relief is provided from federal excise tax and, in most cases, from state income and property taxes.[44]

b. Deductible Contributions

Another advantage is the fact that donors' contributions to many EOs are deductible.[45] The deduction is usually available only for donations to organizations qualifying under IRC section 501(c)(3) (called "501(c)(3)" or "charitable" organizations).[46] However, IRC § 501(c)(6) provides for similar treatment for trade associations because contributions are deductible as business expenses under IRC section 162.[47] Furthermore, subsidiary charitable foundations can be formed to collect deductible contributions which can then be funneled into organizations that are not otherwise qualified.[48]

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41 *Id.*

42. Anne Swardson, *Blue Cross Faces Loss of Its Tax Break*, WASH. POST, Nov. 15, 1985, at A23.

43. HOPKINS, *supra* note 1, § 2.2, at 31. This general advantage has certain exceptions, (e.g., the UBIT, discussed *infra* part III) as well as the tax on excessive legislative activities, the tax on certain political activities or (if private foundations) a variety of excise taxes and the tax on net investment income. *Id.* Except for the tax on unrelated business income these various taxes are beyond the scope of this paper.

44. *Id.* § 2.2.

45. *Id.* As discussed, *supra* note 3, the charitable deduction contribution is, for the most part beyond the scope of this paper.

46. HOPKINS, *supra* note 1, § 2.2.

47. *Id.*

48. *Id.*

c. Increased Likelihood of Funding

EOs, especially charitable ones, are more likely to receive grants from private foundations or state and federal agencies. This is because foundations can distribute funds to public charities in satisfaction of the mandatory payout requirements, and also, because many state and local governments make grants or contract only with EOs.[49]

d. Other Opportunities

Other advantages[50] of EO status include an allowance for tax sheltered annuities,[51] exemption from unemployment tax,[52] preferred mailing rates,[53] exemption from gaming restrictions and taxes,[54] exemption from federal price discrimination laws[55] and exemption from user fees on permits for industrial use of specially denatured distilled spirits.[56]

4. Disadvantages of EO Status

To obtain and maintain these advantages, EOs are subject to stringent application, operation, and reporting requirements.

a. Application Requirements

Most charitable EOs and certain other EOs[57] must apply to the Internal Revenue Service ("IRS") for recognition[58] of their tax-exempt status within fifteen months from the end of the month in which they were organized.[59] Other EOs have no preliminary application requirements. For EOs with no such preliminary requirements, the IRS may issue special rulings or determination letters if the EO desires certainty.[60]

b. Operating Restrictions and Requirements

Actual operating restrictions and requirements vary with each type of EO. As discussed throughout Section II, restrictions and requirements are

49. *Id.*

50. *Id.*

51. I.R.C. § 403(b) (1994).

52. I.R.C. § 3306(c) (1994).

53. 39 U.S.C. §§ 4355(a); 39 U.S.C. 4452(d) (1994).

54. 18 U.S.C. § 1955 (1994); United States v. Hawes, 529 F.2d 472, 481 (5th Cir. 1976).

55. 15 U.S.C. §13(a)-(c) (1994).

56. I.R.C. § 5276(c) (1994).

57. In addition to organizations described in I.R.C. § 501(c)(3) (1994), organizations desiring EO status by reason of I.R.C. §§ 501(c)(9), (17) or (20) (1994) must file with the IRS for recognition of their exempt status.

58. While only Congress can "grant" a tax exemption, the IRS can "recognize" it. *See, e.g.*, Maryland Savings-Share Ins. Corp. v. United States, 400 U.S. 4 (1970).

59. I.R.C. § 508(a) (1994), Treas. Reg. §1.508-1(a)(2)(I) (1995). *See, e.g.*, Peek v. Commissioner, 73 T.C. 912 (1980); Rev Rul. 90-100, 1990-2 C.B. 157.

60. Rev. Proc. 92-4, 1992-1 I.R.B. 66.

placed on the EOs' organizational structure, activities, and use of revenues.

c. Annual Returns

EOs must maintain their status by filing annual information returns.[61] These returns are in the nature of a self-audit which include information about gross income, receipts, and disbursements.[62]

C. Tests for Determining EO Status

1. Charitable Organizations—Public Charities

EOs authorized under section 501(c)(3) are loosely termed "charitable" organizations.[63] Each organization must be scrutinized to determine whether it meets many, often vague, standards and tests. The most important standards and tests are contained in the statutory and common law definitions of a "charitable" organization, the organizational and operational requirements, the "primary purpose" rule, and the doctrines barring private inurement, legislative activities, and political campaign activities.

a. Charitable Organizations Defined

Determining the meaning and scope of the word "charitable" in federal tax law is difficult.[64] IRC section 501(c)(3) and the underlying regulations specify broadly that charitable organizations include educational, scientific and religious organizations (along with five other specifically named categories).[65] However, this broad definition does not clarify the matter.

Each type of charitable organization is further defined. For example, the word "educational" from the broad definition is subdefined by regulation and distinguished from the term "mere opinion."[66] Despite the additional definition, the meaning of "educational" has been much litigated and the real standards remain elusive. The Court of Appeals for the District of Columbia concluded in 1979 that the term "educational" was unconstitutionally vague

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61. I.R.C. § 6033(a)(1) (1994); Treas. Reg. § 1.6033-2(a)(1) (1995).

62. *Id.* HOPKINS, *supra* note 1, Ch. 37 (Chapter 37, discuss these requirements in detail).

63. Treas. Reg.§ 1.501(c)(3)-1(d)(2) (1995) provides an expansive federal tax definition of the term "charitable." There are several ways for an organization to qualify as a "charitable" entity. HOPKINS, *supra* note 1, § 5.4, at 76.

64. *See* Note, *Developments—Nonprofit Corporations* 105 HARV. LAW. REV. 1578, 1615 (1992). *See also* HOPKINS, *supra* note 1, §§ 5.1-5.2, at 69-72.

65. I.R.C. § 501(c)(3) (1994) provides exemption for the following:

> Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment). or for the prevention of cruelty to children or animals. . . .

66. Treas. Reg. § 1.501(c)(3)-1(d)(3) (1995).

and that the IRS used the term to improperly condemn the content of an organization's views.[67] Now, the IRS simply reviews "the method by which the advocate proceeds from the premises he furnishes to the conclusion he advocates."[68] What this means, essentially, is that the IRS looks at "all the facts and circumstances."[69] Thus, the definitions aren't much help.

Defining a religious organization is no less difficult than defining an educational one. Religious organizations are treated specially, however, because of the constitutional separation of church and state. It is virtually impossible for the federal government to challenge an organization's claim that it is a religious organization simply because of the unorthodox nature of the religion.[70] If religious organizations are challenged, it is on the basis that they are a commercial enterprise for private gain[71] or that they engage in inappropriate social activities.[72]

Common law must also be considered when defining the scope of charitable EOs. The judicially crafted "public policy" doctrine gives the IRS authority to revoke or deny an organization's tax-exempt status if it has or will engage in such activities as operating a racially discriminatory school,[73] or in an activity that is violent or illegal.[74] This policy was most clearly enunciated by the Supreme Court in 1983.[75] The Court concluded that a charitable entity "must demonstrably serve and be in harmony with the public interest."[76] The entity's "purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred."[77] Discrimination and other violent or illegal activities are not allowed even if they are imposed on the basis of sincerely held religious beliefs.[78]

b. The Organizational and Operational Tests

By regulation, a charitable organization must meet both the "organiza-

67. Big Mama Rag, Inc. v. United States, 631 F.2d 1030 (D.C. Cir. 1980), *rev'g* 494 F. Supp. 423 (D.D.C. 1979).

68. National Alliance v. United States, 710 F.2d 868 (D.C.Cir. 1983).

69. Rev. Proc 86-43, 1986-2 C.B. 729.

70. See discussion in HOPKINS, *supra* note 1, § 9.2, at 203.

71. Riker v. Commissioner, 244 F.2d 220 (9th Cir. 1957), *cert. den.*, 355 U.S. 839 (1957).

72. First Libertarian Church v. Commissioner, 74 T.C. 396 (1980).

73. *Id.*

74. *See* Synanon Church v. United States, 579 F. Supp. 967, 978-79 (D.D.C.1984), *aff'd*, 820 F.2d 421 (D.C. Cir. 1987); Church of Scientology of California v. Commissioner, 83 T.C. 381 (1984), *aff'd* 823 F.2d 1310 (9th Cir. 1987), *cert. den.*, 486 U.S. 1015 (1988).

75. Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

76. *Id.* at 591-92.

77. *Id.*

78. *Id.*

tional" and the "operational" tests. Failure to satisfy either one will prevent qualification as a charitable EO.[79]

To satisfy the organizational test, the organizational documents must (1) limit the organization's purposes to one or more of the listed exempt purposes,[80] and (2) not expressly empower the organization to engage in any activity (other than to an insubstantial degree) outside of its exempt purposes[81] or to allow any assets to revert to the organizers.[82] According to the IRS, the organizational test can be satisfied only by the "creating document". On this matter, the Tax Court stated:

> [T]he organizational test cannot be met by reference to any document that is not the creating document. In the case of a corporation, the bylaws cannot remedy a defect in the corporate charter. A charter can be amended only in accordance with state law, which generally requires filing of the amendments with the chartering authority. In the case of a trust, operating rules cannot substitute for the trust indenture. In the case of an unincorporated association, the test must be met by the basic creating document and the amendments thereto, whatever the instrument may be called. Subsidiary documents that are not amendments to the creating document may not be called on.[83]

In other words, neither subsequent documents nor actual organizational activities will satisfy the organizational test, even if they are entirely lawful.[84]

To satisfy the operational test, an organization must operate[85] exclusively for one or more exempt *purposes* by engaging primarily in *activities* which accomplish one or more of the exempt purposes specified in IRC section 501(c)(3).[86] The important distinction between activities and purposes may be confusing.[87] The Tax Court attempted to clarify the issue by stating:

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79. Treas. Reg. § 1.501(c)(3)-1(a) (1995); Levy Family Tribe Foundation v. Commissioner, 69 T.C. 615, 618 (1978).

80. Treas. Reg. § 1.501(c)(3)-1(d) (1995).

81. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (1995).

82. Treas. Reg. § 1.501(c)(3)-1(b)(4) (1995). *See,* Chief Steward of the Ecumenical Temples and the Worldwide Peace Movement and His Successors v. Commissioner, 49 T.C.M. (CCH) 640 (1985); Church of Nature in Man v. Commissioner, 49 T.C.M. (CCH) 1393 (1985).

83. Colorado State Chiropractic Society v. Commissioner, 93 T.C. 487 (1989). *Cf.* I.R.S. Exempt Organizations Handbook (IRM 7751) § 332(2).

84. HOPKINS, *supra* note 1, § 6.1, at 113 (setting forth the provisions which must be in the creating documents as well as those which may be contained therein).

85. Well-drafted articles of incorporation are not sufficient.

86. *See, e.g.*, Rev. Rul. 72-369, 1972-2 C.B. 245; *see also* Treas. Reg. § .501(c)(3)-1(c)(1) (1995).

87. HOPKINS, *supra* note 1, § 6.2, at 118.

> Under the operational test, the *purpose* towards which an organization's activities are directed, and not the nature of the activities themselves, *is ultimately dispositive* of the organization's right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a) .... [I]t is possible for... an activity to be carried on for more than one purpose. ... The fact that ... [an] activity may constitute a trade or business does not, of course, disqualify it from classification under section 501(c)(3), provided the activity furthers or accomplishes an exempt purpose. ... Rather, the critical inquiry is whether ... [an organizations's] primary purpose for engaging in its ... activity is an exempt purpose, or whether its primary purpose is the non exempt one of operating a commercial business producing net profits for ... [the organization] .... Factors such as the particular manner in which an organization's activities are conducted, the commercial hue of those activities and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose.[88] (emphasis added).

The operational test is used as a vehicle for applying the "private benefit" test:[89] that is, an EO will fail to satisfy the operational test if it confers a private benefit. For example, a private benefit was conferred on the Republican Party where school trained political campaign officials and nearly all of the school's graduates were employed by the Republican Party.[90] Similarly, a private benefit was conferred on beauty pageant organizers where a scholarship fund granted scholarships to beauty pageant contestants who, in return, were contracturally required to perform for the pageant organizers.[91] Even though the school and the scholarship fund would otherwise have qualified for EO status, they failed the operational test because the organizations' sole purpose was to confer a private benefit upon third parties. If the private benefit had been "insubstantial," the operational test would have been satisfied.[92]

The operational test is also used as a vehicle to apply other tests for tax-exempt eligibility. Most notably, the operational test has been linked to the evolving test of commerciality discussed in Section IV.

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88. B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 356-57 (1978); Ohio Teamsters Educ. and Safety Training Fund v. Commissioner, 77 T.C. 189 (1981), *aff'd*, 692 F.2d 432 (6th Cir. 1982).

89. The private benefit rule is distinct from and more broad than the "private inurement" doctrine. *See* part II.C.1.e. A private benefit can be conferred upon "disinterested persons" whereas private inurement only occurs where "insiders" are involved.

90. Am. Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

91. Miss Georgia Scholarship Fund, Inc. v. Commissioner, 72 T.C. 267 (1979).

92. *See* Nat'l Foundation, Inc. v. United States, 87-2 U.S.T.C. (CCH) ¶ 9602 (Cl. Ct. Oct. 30, 1987)(holding an organization that principally administers projects funded and recommended by donors, for a commission, qualifies as a charitable entity).

c. The "Primary Purpose" Rule

IRC section 501(c)(3) requires that an EO be organized and operated "exclusively" for an exempt purpose.[93] However, as previously noted,[94] the existence of an inconsequential nonexempt purpose does not necessarily destroy an organization's charitable status.[95] As a result, what is often called the "exclusively" rule is more correctly called the "primary purpose" rule.[96]

An inquiry under the primary purpose rule should be made in two steps.[97] The first step is to ask whether a *non*exempt purpose exists. If it does, the second step is to ask whether the nonexempt purpose is a primary or substantial purpose. An exemption is precluded only where both answers are positive. By using this two-step inquiry, different courts have determined that a charitable entity violates the primary purpose rule when it pays retirement benefits to its members,[98] but not when it provides them with medical care.[99] The retirement benefits were disallowed because their provision to members was a substantial nonexempt activity. Medical care was allowed because it furthered the EO's exempt religious purposes.

d. Profitable Activities

Profit making activities are *not* an absolute bar to EO status if the activities accomplish or further an exempt purpose.[100] In fact, one court indicated

93. In this context, it is important to reiterate that "purposes" are not "activities." See the related discussion, *supra* part II.C.1.b. One of the few court decisions to fully explore and properly apply this requirement as being a focus on purposes rather than activities is Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978) (holding the sale of handicrafts is neither an exempt purpose or a nonexempt purpose; "[r]ather, such sale is merely an activity carried on by . . . [the organization] in furtherance of its exempt purposes.") *But, Cf.* The Newspaper Guild of New York, Times Unit—The New York Times College Scholarship Fund v. Commissioner, 57 T.C.M. (CCH) 812 (1989) (IRS claimed the EO's activities were similar to those of a commercial entity).

94. See discussion, *supra* part II.C.1.b.

95. Universal Church of Jesus Christ, Inc. v. Commissioner, 55 T.C.M. (CCH) 144(1988), *citing* Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945).

96. *United Church of Jesus Christ, Inc.*, 55 T.C.M. at 144. Some cases require even less than a primary purpose—e.g., one court required only an "adequate fulfillment" of an exempt purpose. Monterey Pub. Parking Corp. v. United States, 481 F.2d 175 (9th Cir. 1973). The IRS does not concur with this lesser standard. Rev. Rul 78-86, 1978-1 C.B. 144.

97. HOPKINS, *supra* note 1, § 12.1, at 250-51 discussing *Aid to Artisans, Inc. v. Commissioner, supra* note 93.

98. Policemen's Benevolent Ass'n of Westchester County, Inc. v. Commissioner, 42 T.C.M. (CCH) 1750 (1981).

99. Bethel Conservative Mennonite Church v. Commissioner, 746 F.2d 388 (7th Cir. 1984).

100. *See, e.g.*, Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F.2d 148, 156 (3d Cir. 1984)(refusing to endorse the view that accumulated cash automatically constitutes undue commerciality by rejecting the notion that the volume of business defines the purpose of an organization and stating that "the inquiry must remain that of determining the purpose to which the increased business activity is directed").

that the greater the organization's profits, the greater the likelihood that it's purposes are tax-exempt.[101] According to this court, an organization making a "staggering amount of money" and generating an "astounding profitability" could not be replicated in a commercial context.[102] This was an extreme case, however, and the decision was overturned on appeal.

It is most often held that an item can be sold for a profit only if the item is "closely associated with and incidental to" the organization's tax-exempt purpose and bears "an intimate relationship to the proper functioning" of it.[103] Thus, an EO can to sell religious publications to members of its religious following for a relatively small profit.[104] However, an EO cannot publish and sell nondenominational religious tracts at a competitive price if such activities yield substantial accumulated profits and if such activities are the organization's primary concern.[105] As one court stated, "[if such broad and profitable activities led to EO status, then] every publishing house would be entitled to an exemption on the ground that it furthers the education of the public."[106]

Unfortunately, the line between an allowable profit and one that is forbidden is becoming increasingly difficult to draw. As will be seen in Section IV, the court-developed "commerciality" doctrine and the "profit motive" test adopted from IRC section 162 are blurring the boundaries.

e. The Private Inurement Doctrine

The "private inurement" doctrine[107] prohibits an organization from allowing its net earnings[108] (other than an incidental part[109]) to inure to the

101. Am. Bar Endowment v. United States, 84-1 U.S.T.C. (CCH) ¶ 9204 (Cl. Ct. Jan. 31, 1984), *rev'd,* 477 U.S. 105 (1986).

102. *Id.*

103. Saint Germain Found. v. Commissioner, 26 T.C. 648 (1956).

104. *Id.*

105. *Id. Cf.* Scripture Press Found. v. United States, 285 F.2d 800, (Ct.Cl. 1961), *cert den.*, 368 U.S. 985 (1962).

106. Fides Publishers Ass'n v. United States, 263 F.Supp. 924, 935-36 (N.D.Ind. 1967).

107. The private inurement doctrine is different than the prohibitions on private benefit. *See supra* note 89.

108. The term "net earnings" has been interpreted in both the strict accounting sense *See, e.g.,* Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960); *See generally,* Carter v. United States, 973 F.2d 1479, 1487 (9th Cir. 1992). The IRS has developed criteria for assessing compensation arrangements based upon a percentage of the tax-exempt organization's gross revenues considering (1) whether the compensation paid is reasonable, whether the agreement was negotiated at arm's-length, whether the service provider had control over the conduct of the organization and whether the payments have a "real discernible business purpose. HOPKINS, *supra* note 1, § 13.4, at 292-93.

109. The IRS has allowed private inurement as a matter of law and practice so long as the private inurement is "incidental".

benefit of private shareholders[110] or "insiders."[111] This prohibition is not limited to the distribution of dividends, but also applies to the conferral of any direct or indirect benefit.[112] Insiders may not receive EO funds except as reasonable payment for goods and services.[113] There is no requirement that services be donated,[114] but compensation must be reasonable and not excessive.[115] A large salary is more likely to be considered unreasonable and excessive if family members are employed or if an employee receives more than one form of compensation (fees, commissions, or royalties in addition to wages).[116]

f. Ban on Legislative Activities

No substantial part of a charitable EO's activities may constitute "carrying on propaganda, or otherwise attempting to influence legislation."[117] A public charity may comply with these rules under the "substantial part test" or the elective "expenditure test."[118]

(1) The Substantial Part Test.

Under the substantial part test, the word "legislation" is defined broadly. This broad definition means that an EO may not attempt to influence an action by Congress, a state legislature, a local council or a similar governing

110. A few states still permit a nonprofit corporation to issue stock.

111. I.R.C. § 501(c)(3) (1994). The IRS has stated that all persons performing services for an organization are "insiders." *See* Gen. Couns. Mem. 39670 (Oct. 14, 1987); *See also,* Gen. Couns. Me. 39498 (Apr. 24, 1986). HOPKINS, *supra* note 1, § 2.2, at 35 believes this is "obviously" an overly broad reading of the of the concept.

112. Gen. Couns. Mem. 38459 (July 31, 1980); Gen. Couns. Mem. 39670 (Oct. 14, 1987). *See also* Gen. Couns. Mem. 39862 (Dec. 2, 1991) (hospitals may jeopardize their tax-exempt status by forming joint ventures with doctors through which doctors are rewarded for referring patients to hospitals, because such arrangements violate the prohibition on private inurement); Treas. Reg. §§ 1.501(c)(3)-1(d)(1)(ii), 1.501(a)-1(c), 1.501(c)(3)-1(c)(2) (1994); Ginsburg v. Commissioner, 46 T.C. 47 (1966); Rev. Rul. 76-206, 1976-1 C.B. 154.

113. I.R.S. Exempt Organizations Handbook (IRM 7751) § 342.1(1)-(3).

114. *See, e.g.,* Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

115. *Id.*

116. B.H.W. Anesthesia Found., Inc. v. Commissioner, 72 T.C. 681 (1979) (benefits received by physician were reasonable considering the skills involved the nature of the services provided). *But compare,* Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969), *cert den.*, 397 U.S. 1009 (1970); Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980) *aff'd*, 670 F.2d 104 (9th Cir. 1981); Unitary Mission Church of Long Island v. Commissioner, 74 T.C. 507 (1980), *aff'd*, 647 F.2d 163 (2nd Cir. 1981).

117. I.R.C. § 501(c)(3) (1994). For a more complete explanation, see HOPKINS, *supra* note 1, Ch. 14, at 301-26.

118. Treas. Reg. §1.501(h)-1(a)(1)-(2) (1995).

119. Compare Treas. Reg. §1.501(c)(3)-1(c)(3)(ii) (1995) with Treas. Reg. § 4911(e)(2) (1995).

body or, in a referendum or an initiative, an action by the general public.[119] An EO is not prohibited from attempting to influence an action of the executive branch or by independent regulatory agencies.[120] Such action is not considered "legislation."

Under the substantial part test, "direct" lobbying is forbidden but indirect or "grass roots" lobbying is allowed.[121] An EO cannot directly present testimony at public hearings held by legislative committees, correspond and confer with legislators and their staffs, or publish documents advocating specific legislative action.[122] However, an EO can indirectly appeal to the general public to contact legislators or take other action.[123]

An EO operating under the substantial part test must also determine whether it's lobbying efforts are "substantial," a necessarily subjective endeavor.[124] One approach to measuring substantiality has been to calculate the percentage of revenues an EO spends on legislative efforts, and compare it to the EO's total expenditures for charitable purposes.[125] However, this test has been rejected where a minor expenditure by a prestigious EO has a "substantial" impact on legislation.[126]

(2) The Expenditure Test.

Because of the subjectivity and uncertainty inherent in the substantial part test, Congress developed the expenditure test which was ultimately subsumed within the Tax Reform Act of 1976.[127] The expenditure test attempts to utilize mechanical tests for measuring permissible and impermissible lobbying expenditures.[128] The expenditure test is more lenient because the term "legislation" is defined more restrictively (thus allowing more "non-legislative" activities).[129]

Five categories of activities are specifically allowed under the expenditure test. An EO may: (1) make available the results of nonpartisan analy-

120. *E.g.*, Ernest Gellhorn, *Public Participation in Administrative Proceedings*, 81 YALE L.J. 359 (1972).

121 HOPKINS, *supra* note 1, §14.3, at 303.

122. Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii) (1995).

123. *See, e.g.*, Roberts Dairy Co. v. Commissioner, 195 F.2d 948 (8th Cir. 1952) *cert. den.*, 344 U.S. 865 (1952).

124. S. Rep. No. 94-938 (Part 2), 94th Cong., 2d Sess. (1976), *cited by* HOPKINS *supra* note 1, § 1.4 n.n.74.

125. Kuper v. Commissioner, 332 F.2d 562 (3d. Cir. 1964), *cert. den.*, 379 U.S. 920 (1964).

126. Haswell v. United States, 500 F.2d 1133, 1142 (Ct. Cl. 1974), *cert. den.*, 419 U.S. 1107 (1975).

127. I.R.C. §§ 501(h), 504, 4911 and 6033(b)(8) (Supp. 1995).

128. An explanation of the formulas can be found at HOPKINS, *supra* note 1, § 14.4, at 312-14.

129. *Id.*

sis, study, or research; (2) provide technical advice or assistance to a governmental body in response to a written request for such advice or assistance from the body; (3) appear before or communicate with a governmental body regarding a decision the body might make about the existence or powers of the EO; (4) communicate with bona fide EO members about legislation or proposed legislation of interest to the EO, unless the communication directly encourages the members to influence the legislation; and (5) routinely communicate with a governmental body.[130]

g. Prohibitions Against Political Campaign Activities

EOs may not participate or intervene in a "political campaign" with respect to an individual who is a "candidate for public office."[131] Unlike the ban on legislative activities, the proscription against political campaign activities is absolute.[132] Despite the absolute nature of the statutory ban, the courts, as a practical matter, ignore "slight" or "comparatively unimportant" deviations.[133]

The ban is applied differently to political *campaign* activities than it is to mere political activities. An EO cannot contribute to the political campaign of a candidate for public office[134] or endorse a candidate.[135] However, after much litigation, EOs have been allowed to cautiously enter the political milieu if they display a charitable (e.g., educational, or religious) purpose. Thus, EOs are now permitted to issue "report cards" on legislator's votes,[136] sponsor public forums for political debates or impartial lectures on specific political topics,[137] and donate to libraries the campaign speeches and writings of historically important political candidates.[138]

The ban on political campaign activities is confusing to many, including managers of charitable organizations and the courts.[139] For example, "legislative activities" are confused with "political activities" which in turn are confused with "political campaign activities."[140] In addition, exceptions to the

130. HOPKINS, *supra* note 1, § 14.3, at 307-08.

131. I.R.C. § 501(c)(3) (Supp. 1995). *See also* HOPKINS, *supra* note 1, §15.

132. Gen. Couns. Mem. 39694 (Jan. 22, 1988).

133. St Louis Union Trust Co. v. United States, 374 F.2d 427, 431-32 (8th Cir. 1967).

134. United States v. Dykema, 666 F.2d 1096, 1101 (7th Cir. 1981), *cert. den.*, 456 U.S. 983 (1982), *rehearing den.* 458 U.S. 1132 (1982) ("It should be noted that exemption is lost . . . by participation in any political campaign on behalf of any candidate for public office").

135. Rev. Rul. 76-456, 1976-2 C.B. 151.

136. Gen. Couns. Mem. 38444 (July 15, 1980).

137. Rev. Rul. 66-256, 1966-2 C.B. 210.

138. Rev. Rul. 70-321, 1970-1 C.B. 129.

139. HOPKINS, *supra* note 1, § 15.8.

140. *Id.* (referring particularly to Am. Campaign Academy v. Commissioner, 92 T.C. 1053, 1062 (1989) and Christian Echoes Nat'l Ministry, Inc. v. United States, 470 F.2d 849 (10th

various requirements are created because certain undertakings are protected by the First Amendment. For example, an EO may permissibly engage in a boycott (e.g., NOW's convention boycott campaign[141]) or institute litigation (e.g., Exxon's oil spill[142]).

2. Charitable Organizations—Private Foundations

Essentially, a private foundation is a "charitable organization" that is controlled and funded from a single source.[143] The "private" aspect of a private foundation is the funding source rather than the type of activities in which it participates.

Like public charitable EOs, private foundations are subject to organizational and operational requirements. However, the rules are more extensive for private foundations. The organizing documents of the foundation must set forth the way in which it will comply with the requirements regarding self-dealing, mandatory distributions, business holdings, and jeopardizing investments.[144]

a. Prohibition Against Self-Dealing

An overriding prohibition for private foundations is precluding "self-dealing."[145] *All* transactions between a private foundation and any "disqualified person"[146] are prohibited. It is immaterial whether a self-dealing transaction benefits or harms the foundation.[147] Congress' Joint Committee on Internal Revenue Taxation discussed several self-dealing transactions not harmful to the foundation, but that were nevertheless prohibited:

> The use of a private foundation to improperly benefit those who control the foundation [occurs] . . . where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs cash and cannot find a ready buyer; (2) lends money

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Cir. 1972), *cert. den.*, 414 U.S. 864 (1973)).

141. Missouri v. Nat'l Org. for Women, Inc., 467 F. Supp. 289 (W.D. Mo. 1979), *aff'd* 620 F.2d 1301 (8th Cir. 1980), *cert. den.* 449 U.S. 842 (1980).

142. Rev. Rul. 80-278, 1980-2 C.B. 175.

143. HOPKINS, *supra* note 1, §§ 16.1, 17, 17.1.

144. HOPKINS, *supra* note 1, Ch. 17, at 362-63, indicates that Congress imposed these additional requirements based upon the belief that abuses were especially prevalent with privately controlled foundations.

145. The ban against self-dealing is analogous but not identical to the prohibition against private inurement for public charities (discussed *supra* part II.C.1.e.) and the ban against conferring a private benefit (discussed *supra* part II.C.1.b.).

146. A "disqualified person" is one with a particular relationship with the private foundation and can include a substantial contributor (including the creator of the foundation manager, 20 percent owner, family member as well certain types of corporations or partnerships, trusts or foundations and government officials. I.R.C. § 4941(d)(1) (1994); Treas. Reg. § 53.4941(d) (1995).

> to the donor with adequate security and at a reasonable rate of interest, but at a time when the money market is too tight for the donor to readily find alternate sources of funds; or (3) makes commitments to lease property from the donor at a fair rental when the donor needs such advance leases in order to secure financing for construction or acquisition of property.[148]

Among other things, leasing property, extending credit, paying compensation, furnishing goods, services or facilities, and transferring use of income or assets have been specifically forbidden.[149]

Stringent sanctions (they are officially called "excise taxes" rather than sanctions)[150] are imposed for violation of the self-dealing prohibition.[151] Willful and repeated violations of these prohibitions will result in involuntary termination of EO status and the imposition of additional taxes.[152]

b. Mandatory Distributions

A private foundation is required to make distributions for charitable purposes.[153] Mandatory distributions are required to prevent a donor from obtaining a charitable deduction when the donation is not, in fact, used for its ostensible charitable purpose.[154] The mandatory distribution equals five percent of the value of the non-charitable assets[155] of the foundation *and* the minimum investment return plus any repayments previously treated as qualifying distributions or previously set aside for a charitable project but not so used.[156]

c. Excess Business Holdings

Private foundations are limited in their ability to acquire or retain holdings in business enterprises.[157] Unless the holdings exist in a functionally-related business,[158] a private foundation (including all disqualified persons)

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147. I.R.C. § 4941(d)(1), Treas. Reg. § 53.4941(d).

148. General Explanation of Tax Reform Act of 1969, 91st Cong., 2d Sess. 30-31 (1970) [hereinafter Joint Committee, TRA of 1969], *cited by* HOPKINS *supra* note 1, § 20.1 n.n.2. *See also*, I.R.C. § 4946(a)(1)(A)-(I) (1994).

149. See discussion contained in HOPKINS, *supra* note 1, § 20.3, at 436-51.

150. *In re* Unified Control Systems, Inc., 586 F.2d 1036 (5th Cir. 1978)

151. I.R.C. §§ 4941, 4961-62 (1994); Treas. Reg. §§ 53.4941, 53.4961-62 (1995).

152. I.R.C. § 507 (1994); Treas. Reg. § 1.507 (1995).

153. I.R.C. § 4942 (1994).

154. Joint Committee, TRA 1969, *supra* note 148.

155. I.R.C. § 4942(e)(1)(A) (1994). The foundation must compute the "aggregate fair market value of all assets of the foundation" but certain assets are excluded. Treas. Reg.§ 53.4942(a)-2(c)(3) (1995).

156. I.R.C. § 4942(d)(1) (1994).

157. I.R.C. § 4943(c)(2)(A) (1994).

158. I.R.C. §§ 4943(d)(3)(A), 4942(j)(4) (1994).

is limited to holding twenty percent of the voting stock or other interest in a business, or thirty-five percent if effective (or actual) control can be shown to exist elsewhere.[159] This requirement is imposed to prevent business interests from compiling income rather than distributing it for charitable purposes.[160]

d. Jeopardizing Investments

Private foundations are prohibited from making "jeopardizing investments."[161] The rationale for this prohibition is based on the fact that charity is supposed to benefit from a foundation's existence. However, if a foundations's assets are jeopardized, the assets may not be available for charitable purposes.[162]

To fulfill the investment requirement, foundation managers must exercise ordinary business care and prudence (the "prudent trustee" approach) under the facts and circumstances that exist at the time of the investment.[163] There is no hard and fast rule about what constitutes a jeopardizing investment. However, the IRS will scrutinize foundation managers when traditionally "risky" investments are made, such as trading in securities on margin, trading in commodity futures, investments in oil and gas syndications, or trading in "puts," "calls," and "straddles."[164]

3. Social Welfare Organizations

A social welfare organization is an organization created and designed to carry out its purposes through the development and implementation of programs impacting on community, state and/or national policy-making.[165] "Social Welfare" is equated by regulation with the "common good and general welfare" and with "civic betterments and social improvements."[166] It does not include political campaign activities or other activities that primarily constitute "carrying on a business with the general public in a manner similar to organizations which are operated for profit."[167]

Like charitable organizations, social welfare organizations must be

159. I.R.C. § 4943(c)(2)(C) (1994).

160. Joint Committee, TRA of 1969, *supra* note 148, at 41.

161. I.R.C. § 4944 (1994).

162. Joint Committee, TRA of 1969, *supra* note 148.

163. S. Rep. No. 91-552, 91st Cong., lst Sess. (1969), at 46, *cited by* HOPKINS *supra* note 1, § 1.4 n.n.72.

164. HOPKINS, *supra* note 1, § 23.1, at 487.

165. I.R.C. § 501(c)(4) (1994) (provides tax exemption for "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare . . ."). *See generally,* HOPKINS *supra* note 1, ch.28.

166. Treas. Reg. 1.501(c)(4)-1(a)(2)(i) (1995).

167. Treas. Reg. 1.501(c)(4)-1(a)(2)(ii) (1995).

operated "primarily" for the promotion of social welfare. The difference is that social welfare organizations must work for the benefit of those in a "community." A "community" is difficult to define but may *not* be a select group of individuals.[168] Thus, a homeowners' association would not be exempt from income tax if it maintained the individual homes of homeowners in the group,[169] but would be exempt if it maintained common property which can be used and enjoyed by the general public.[170]

Social welfare organizations differ from charitable organizations in that they may, as "action" organizations, engage in legislative activities[171] and certain political campaign activities so long as the principal purpose of the organization is to advance social welfare.[172] But for the "action" capabilities of the social welfare EOs, they are quite similar to charitable EOs, and often, a single organization can qualify for exempt status as either.[173]

4. Business Leagues

Business leagues are associations of persons who have a common business interest.[174] The association must exist to promote the common business interest of the members, and not to engage in business itself. If the organization engages in any commercial business, even with minimal profit, it will lose its exemption.[175] Direct lobbying is allowed.[176]

The definition of "business" for purpose of the business league exemption is broad. It encompasses any activity carried on for the production of income, including the professions, chambers of commerce, real estate boards, boards of trade and professional football leagues.[177] However, the exemption is not available to aid one group in competition with another group in the same industry. For example, the exemption was denied to an organization of muffler dealers which confined its membership to dealers franchised by Midas

168. Compare the history set forth in Snowling, *Federal Taxation of Homeowners' Associations*, 28 TAX LAW. 117 (1974) with I.R.C. § 528 (1994) which provides an elective tax exemption for condominium management and residential real estate management associations.

169. Commissioner v. Lake Forest, Inc., 305 F.2d 814 (4th Cir. 1962); Rev. Rul. 56-225, 1956-1 C.B. 58.

170. Rev. Rul. 74-99, 1974-1 C.B. 131.

171. E.g., Rev. Rul. 68-656, 1968-2 C.B. 216.

172. Rev. Rul. 81-95, 1981-1 C.B. 332. However, a social welfare organization may be subject to the "political organization taxable income."

173. *Id.*

174. I.R.C. § 501(c)(6) (1994).

175. Treas. Reg. § 1.501(c)(6)-(1) (1995); Engineers Club of San Francisco v. United States, 791 F.2d 686 (9th Cir. 1986).

176. Rev. Rul. 61-177, 1961-2 C.B. 117.

177. *See* I.R.C. § 501(c)(6) (1994); HOPKINS, *supra* note 1, Ch. 29, at 572-96.

International Corporation.[178]

Exemption will be denied where there is a lack of a "business" interest. Thus, associations of hobbyists[179] and motorists[180] cannot be exempt from taxation as business leagues.

Professional organizations such as medical societies or bar associations are presumed to be business leagues rather than charitable organizations, even though they may engage in charitable and educational activities.[181] This presumption can be overcome by showing that the organization does not direct itself at, or concern itself with, the protection or promotion of the business interests of its professional members.[182] An EO is required to be a business league, however, if it engages to any substantial degree in public relations, professional policing, or social activities, even if it merely exists to promote good relationships among its members.[183]

5. The Political Organization

A political organization is provided tax exempt status by virtue of IRC section 527. The political action committee ("PAC") is probably the most recognized form of this EO. However, a candidate's bank account used for depositing contributions and disbursing campaign expenses qualifies as a political organization, as does a candidate's newsletter fund.

A political organization can be taxed on its "political organization taxable income."[184] Such income includes amounts spent for improvements to its facilities or for equipment that is not necessary for an exempt function.[185]

6. Other EOs

Tax exempt status is granted to other organizations including social clubs,[186] credit unions,[187] veteran's organizations,[188] and organizations having labor, agricultural or horticultural purposes.[189] EOs of this nature are not notably different from those EOs already reviewed, and are not discussed separately herein.[190]

178. *See, e.g.*, Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472 (1979).
179. Rev. Rul. 66-179, 1966-1 C.B. 139.
180. Am. Automobile Ass'n v. Commissioner, 19 T.C. 1146 (1953).
181. *See, e.g.*, Rev. Rul. 71-504, 1971-2 C.B. 231; Rev. Rul. 71-505, 1971-2 C.B.232.
182. Rev. Rul. 70-641, 1970-2 C.B. 119.
183. HOPKINS, *supra* note 1, § 29.2, at 580.
184. I.R.C. § 527(b) (1994).
185. Treas. Reg. § 1.527-5(a)(2) (1995).
186. I.R.C. § 501(c)(7) (1994).
187. I.R.C. § 501(c)(14) (1994).
188. I.R.C. § 501(c)(19) (1994).
189. I.R.C. § 501(c)(5) (1994).
190. For more information, see HOPKINS, *supra* note 1, Chs. 30, 31, 34.

III. TAXING THE EOS—AN EXCEPTION TO THEIR EO STATUS THE UNRELATED BUSINESS INCOME TAX

A. Background Information

In 1950, Congress acted on its belief that EOs were taking unfair advantage of their exempt status and imposed a tax on every EO's unrelated trade or business income (hereinafter "UBIT").[191] Congress elaborated its purpose for the new legislation:

> The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of . . . [501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.[192]

In other words, UBIT was primarily imposed to protect commercial enterprises from the threat of unfair competition.[193]

Excessive unrelated business income may cause revocation of EO status.[194] However, UBIT was conceived and is currently thought of as a mild and workable alternative to revocation in enforcement of the law of EO status.[195]

UBIT is most often imposed at the corporate rate.[196] Surtaxes are applicable,[197] and estimated quarterly payments must be made.[198] The revenue and expenses associated with UBIT are reported on IRS Form 990-T.

B. UBIT Generally Defined

The Code defines unrelated business income generally as gross income derived by an organization from any unrelated trade or business which is regularly carried on by the organization, less deductions directly connected

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191. *See* I.R.C. § 501(b) (1994). Under the 1950 statute, the tax applied to a limited number of EOS, primarily charitable and trade or labor organizations. It was not until 1969 that Congress extended the tax to virtually all organizations exempt under I.R.C. § 501 (1994).

192. H. Rep. No. 2319, 81st Cong., 2d Sess. (1950), at 36-37, *cited by* HOPKINS *supra* note 1, § 40.1 n.n. 33.

193. In recent years, along with budget deficits and "tax reform" and "tax simplification," an additional rational has come to the fore—that of raising revenue. This more recent development is discussed *infra*, part IV.

194. Gen. Couns. Mem. 39108 (Dec. 23, 1982); Orange County Agric. Soc'y, Inc. v. Commissioner, 893 F.2d 529 (2nd Cir. 1990).

195. *See, e.g.*, Indiana Retail Hardware Ass'n v. United States, 366 F.2d 998 (Ct. Cl. 1966).

196. I.R.C. §§ 1, 11, 12(1) (1994).

197. I.R.C. § 11(b) (1994).

198. I.R.C. § 6154(h); Treas. Reg. § 1.6302-1(a).

with the carrying on of such trade or business.[199] However, most court cases discuss UBIT compliance under the three categories set forth by Treasury Regulation §1.513-1(a).

C. UBIT as Defined by Regulation §1.1513-1(a)

Regulation §1.513-1(a) requires that an EO's gross income be subjected to UBIT if three factors are present: (1) the income is from a trade or business; (2) the trade or business is regularly carried on by the organization; and (3) the conduct of the trade or business is not substantially related to the organization's performance of its tax-exempt functions.

The manner in which the regulation is usually applied is well illustrated in *Iowa State University of Science and Technology v. United States.*[200] Iowa State University operated a television station. The university claimed that the income from the television station furthered its tax-exempt educational purpose because the station was used to train students in the broadcasting industry, provide closed circuit transmissions to classrooms, and provide revenue to support university endeavors. The Court imposed UBIT because the *station's operations* (1) constituted a trade or business, (2) operated frequently and regularly, and (3) were not substantially related to the university's exempt functions. The interpretation of the third prong of the regulatory test was the key to the decision. The Court found that the station's earnings were contributed to and used by the university to support educational operations. However, the "destination" of the income (the university's educational operations) was irrelevant.[201] Rather, the "source" of the income was the station and the station's activities were critical to the analysis. The station operated like a commercial enterprise because its programs were selected in coordination with the station's sales staff to "lure" the largest possible audience and sponsored largely by paid advertisers. The station's activities were much closer to the activities of a commercial television station than those of the average educational station.[202] The station issued eleven hours of local programming per week, compared to nineteen hours per week issued by less profitable educational stations. In addition, the station partially assisted in only five of the university's two thousand courses. The educational activities were deemed incidental under such circumstances.

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199. I.R.C. § 512(a)(1) (1994).

200. 500 F.2d 508 (Ct. Cl. 1974).

201. *Id.* at 518. The court cited the history to the 1950 Act (H. Rept. No. 2319, 81st Cong., 2d Sess. [1950-2 C.B. 380 et seq.]; S. Rept. No. 2375, 81st Cong. 2d Sess. [1950 2-C.B. 483 et seq.]) and referred the reader to the discussion of the history contained in SICO Found. v. United States, 295 F.2d 924, (Ct. Cl. 1961).

202. Iowa State Univ. of Science and Technology, 500 F.2d at 519.

The application of each of the three regulatory requirements is explored in more detail below.

1. "Trade or Business" Defined

As originally conceived, the concept of a "trade or business" was a narrow one. The US Supreme Court observed in 1963 that the "narrow category of trade or business" is a "concept which falls far short of reaching every income or profit making activity."[203] In recent years, however, the IRS and the courts have settled on the view that any activity is a trade or business if it is pursued with a profit motive or is conducted in a commercial manner.[204] Now, it is often said that a trade or business for UBIT purposes constitutes any activity that is carried on for the production of income from the sale of goods or the performance of services.[205]

An EO engages in a trade or business for UBIT purposes even if the EO carries on an activity within a larger complex of activities that furthers a tax-exempt purpose. This requirement, contained in IRC section 513(c), means that the IRS can fragment an EO's activities into components to look for and subject to UBIT those activities that are unrelated to an exempt purpose. This so-called "fragmentation rule" is a significant factor in the imposition of UBIT. The fragmentation rule is also instrumental in the current expansion of UBIT, as discussed further in Section IV.

2. "Regularly Carried On" Defined

Business activities of an EO will be "regularly carried on" if the activities exhibit "frequency and continuity", and are pursued in a manner similar to comparable commercial activities in the private sector.[206] For example, a one-time sale of real or personal property is not an activity that is regularly carried on, and thus does not give rise to unrelated business income.[207] An occasional party, for which an EO hires an orchestra and charges admission to the public, would not be considered frequent and continuous,[208] nor would selling sandwiches at an annual event.[209] However, the frequency and conti-

203. Whipple v. Commissioner, 373 U.S. 193, 197, 201 (1963). *See also,* Blake Constr. Co., Inc. v. United States, 572 F.2d 820 (Ct. Cl. 1978); Gentile v. Commissioner, 65 T.C. 1, 5 (1975).

204. Ditunno v. Commissioner, 80 T.C. 362 (1983). In this case, the tax court rejected the more narrow, traditional requirement. See the discussion contained *infra,* part IV.

205. Treas. Reg. 1.513-1(b) (1995). *See, e.g.*, West Virginia State Medical Ass'n v. Commissioner, 91 T.C. 651 (1988), *aff'd*, 882 F.2d 123 (4th Cir. 1989), *cert. den.*, 493 U.S. 1044 (1990).

206. I.R.C. § 512 (1994).

207. *See, e.g.*, Priv. Ltr. Rul. 79-05-129 (Nov. 7, 1978).

208. S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), at 106-07, *cited by* HOPKINS *supra* note 1, § 40.1 n.n.33.

209. Priv. Ltr. Rul. 79-05-129 (Nov. 7, 1978).

nuity of a particular activity will be considered in its ordinary commercial context. For example, distributing greeting cards during the Christmas season,[210] or operating a track for horse racing during the racing season,[211] would be frequent and continuous activities because the sales and operations last as long as similar activities in the commercial world.

The amount of preparation for an event will also be considered.[212] Publishing advertising in programs for a single sports event or artistic performance would not ordinarily be considered a frequent and continuous activity. Nevertheless, the single event would be deemed regularly carried on if the event was systematically and consistently promoted throughout the year.[213]

3. "Substantially Related" Defined

Gross income derived from a trade or business that is regularly carried on will nevertheless avoid UBIT if the conduct of the trade or business is "substantially related" to the EO's exempt purposes.[214] A trade or business is *related* to an EO's tax-exempt purpose where the activity has a causal relationship to that purpose.[215] Further, a business activity is substantially related only if the profitable activities "contribute importantly" to the accomplishment of the exempt purpose.[216]

The test to determine whether the profitable activities contribute importantly to an exempt purpose is a facts and circumstances test.[217] Among other things, the size and extent of the profitable activities are considered and weighed against the needs created by the exempt purposes. The activities cannot exceed the needs.[218] Thus, a grocery store operating solely to provide training to unemployed residents of the area would be subject to UBIT if it operates "on a much larger scale than is reasonably necessary" to provide the training.[219]

The analysis is made even more complex by the fragmentation rule because profitable activities are broken down into their component parts.[220] For

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210. *See, e.g.,* Priv. Ltr. Rul. 82-03-134 (Sept. 10, 1981).

211. Rev. Rul. 68-505, 1968-2 C.B. 248.

212. Hopkins, *supra* note 1, § 41.3, at 873.

213. *Id.*

214. Treas. Reg. § 1.513-1(a) (1995).

215. Treas. Reg. § 1.513-1(d)(1) (1995).

216. Treas. Reg. § 1.513-1(d)(2) (1995).

217. Treas. Reg. § 1.513-1(d)(2) and Huron Clinic Found. v. United States, 212 F. Supp. 847 (D.S.D. 1962).

218. Treas. Reg. § 1.513-1(d)(3) (1995).

219. *Compare* Rev. Rul. 73-127, 1973-1 C.B. 221 and Rev. Rul. 76-94, 1976-1 C.B. 171.

220. I.R.C. § 513(c) (1994), discussed *supra,* part III.C.3.

example, a scientific organization operating an experimental dairy herd will not be subject to UBIT for selling the milk and cream resulting from its ordinary operations, but will be subject to UBIT for the component of the business which processes the milk and cream and sells it as ice cream or pastries.[221]

Income from dual-use facilities is also subject to a fragmentation analysis.[222] A university that operates athletic facilities designed and equipped for its students may be subject to UBIT if it makes its facilities and personnel available for the conduct of a summer tennis camp.[223] The university can avoid UBIT only by insuring that the tennis camp is exempt for other reasons. To insure exemption, the university must cast the income received as exempt passive rental income,[224] or as income from a separate educational activity for youths.[225]

Court opinions and IRS rulings provide numerous examples of activities that are substantially related to an EO's exempt purpose. The more innovative of these include: the operation of a beauty shop and a barber shop by a tax-exempt senior citizens' center;[226] the sale of members' horses by a tax-exempt horse breeders' association;[227] and the conduct of research and counseling activities for the purpose of promoting business in foreign countries.[228] Examples of activities that were superficially similar to those just listed, but were not substantially related to an exempt purpose include: the sale of heavy-duty appliances to senior citizens by a tax-exempt senior citizens' center;[229] the sale of certain blood components by a tax-exempt blood bank to commercial laboratories;[230] and the conduct of a language translation service by a tax-exempt trade association that promoted international trade relations.[231]

D. Special Definitions under the UBIT Rules

Both the term "gross income" and the word "deductions" have a special meaning in the UBIT context.

1. Gross Income Excludes "Passive" Income

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221. Rev. Rul. 76-94, 1976-1 C.B. 171.

222. See discussion of the "fragmentation rule," *supra,* part III.C.1.

223. Rev. Rul. 76-402, 1976-2 C.B. 177.

224. See discussion *infra,* part III.D.1.

225. Priv. Ltr. Rul. 79-08-009 (Sept. 29, 1978).

226. Rev. Rul. 81-61, 1981-1 C.B. 355.

227. Priv. Ltr. Rul. 81-12-013 (Dec. 9, 1980).

228. Priv. Ltr. Rul. 85-05-047 (Nov. 6, 1984).

229. Rev. Rul. 81-62, 1981-1 C.B. 355.

230. Rev. Rul 66-323, 1966-2 C.B. 216, as modified by Rev. Rul. 78-145, 1978-1 C.B. 169.

231. Rev. Rul. 81-75, 1981-1 C.B. 356

Gross income does not include passive income.[232] This exclusion is based on the theory that passive income does not create a risk of unfair competition.[233] Passive income excluded from the calculation of UBIT includes income from interest, dividends and payments from securities loans, annuities, royalties, and rents (predominantly those from real property).[234] Also excluded are income from gains or losses from the sale, exchange, or other disposition of property other than (a) inventory or (b) property held primarily for sale to customers in the ordinary course of a trade or business.[235]

Some unusual results flow from the passive income exception. For example, an EO[236] can own all of the stock of a for-profit corporation without incurring UBIT or endangering its exempt status even if it receives dividends from the for-profit corporation.[237] Thus, an EO like the U.S. Olympic Team, that exists to develop an amateur sports competition, can profitably license the right to use its name and logo to sell commercial products.[238] Also, an EO can own a building and profitably lease space to others.[239]

An EO must be careful in the passive income area, however, because the passive income rules are complex and may be inapplicable in surprising ways. If an EO's profitable lease arrangement can be labeled a "return of profits" from a joint venturer, the lease income will no longer be excluded from UBIT because the EO is not "merely passively collecting rent."[240] Similarly, if the EO provides maid services under the lease, the lease income will no longer be passive income.[241]

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232. I.R.C. § 512(b) (1994).

233. According to the senate report, "[the] committee believes that [these items] are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income." S. Rep. No. 2375, 81st Cong, 2d Sess. at 30-31 (1950), *reprinted in* 1950-2 C.B. 483, 506, *cited by* Hopkins *supra* note 1, § 40.1 n.n.33.

234. I.R.C. §§ 512(b)(1),(2),(3), (5) (1994). *See also,* Treas. Reg. § 1.512(b)-1(a)-(d) (1995); State Nat'l Bank of El Paso v. United States, 509 F.2d 832 (5th Cir. 1975).

235. I.R.C. § 512(b)(5) (1994). This last category of excluded items includes "gains on the lapse or termination of options, written by the organization in connection with its investment activities, to buy or sell securities." If any of the otherwise-excludable income is produced from property financed through debt, part (or all) of the income may be included in UBIT. I.R.C. §§ 512(b)(4), 514(a)(1) (1994).

236. Except for private foundations discussed *supra,* part II.C.2.

237. *See, e.g.*, Priv. Ltr. Rul. 82-44-114 (Aug. 6, 1982).

238. Priv. Ltr. Rul. 80-06-005 (Oct. 31, 1979).

239. Treas. Reg. § 1.512(b)-1(c)(5) (1995); Rev. Rul. 69-69, 1969-1 C.B. 159. However, unrelated debt-financed income is not subject to this exclusion.

240. Mortimer Berl, *Boot-Strap and Contingent Sales: The Implications of Clay Brown: Problems of the Tax Exempt Organizations: Proposed Legislation*, 25 N.Y.U. INST. FED. TAX. at 701, 711 (1967).

241. *See, e.g.*, Priv. Ltr. Rul. 80-24-001 (Feb. 21, 1980).

2. Restrictive Deduction Rules

Deductions from UBIT are limited and are calculated specially. Deductions are granted only where they are "directly connected with" the conduct of an unrelated business. To be directly connected with the conduct of an unrelated business, an item of deduction must have a "proximate and primary" relationship to the unrelated business. A proximate and primary relationship exists only where expenses are attributable solely to the operation of the unrelated business.[242] In other words, just because an EO operates at an overall loss does not mean it can deduct all of its losses against its unrelated business income. It can deduct only losses that are incurred in generating the income.

The special deduction rules are best illustrated by the treatment of net income derived by an EO from the sale of advertising. If an EO publishes a newsletter with editorials related to its exempt purpose, but the newsletter contains paid advertising,[243] the advertising income is subject to UBIT.[244] If the editorial portions of the newsletter are published at a loss, then the editorial losses may be offset against the advertising income, but losses from other EO activities may not.[245] An EO may allocate the expenses of dual use equipment facilities and personnel used to publish the newsletter but such allocations must have a "reasonable" basis.[246]

It is of the utmost importance that claimed deductions be adequately substantiated.[247] Failure to substantiate a deduction leads not only to disallowance of the deduction, but also to sanctions.[248]

E. Exceptions to the UBIT Rules

Even if a particular activity otherwise constitutes an unrelated trade or business that is regularly carried on, the activity may escape taxation under one of the specific statutory exceptions to UBIT. Five common exceptions are

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242. Treas. Reg. 1.512(a)-1(d) (1995).

243. There is little case law defining "advertising." It has been conceived of as "business listings" consisting of "slogans, logos, trademarks and other information which is similar in content, composition and message to the listings found in other professional journals, newspapers and the 'yellow pages' of telephone directories." Fraternal Order of Police, Illinois State Troopers Lodge No. 41 v. Commissioner, 87 T.C. 747, 754 (1986), *aff'd,* 833 F.2d 717 (7th Cir. 1987).

244. HOPKINS, *supra* note 1, § 41.5, at 907.

245. *Id.*

246. *See,* Treas. Reg. § 1.512(a)-1 (1995); Rensselaer Polytechnic Inst. v. Commissioner, 732 F.2d 1058 (2nd Cir. 1984), (allocation of facility expenses where facility was used for both tax-exempt and unrelated purposes).

247. CORE Special Purpose Fund v. Commissioner, 49 T.C.M. (CCH) 626 (1985).

248. *Id.*

for (1) income generated by volunteers, (2) income from sales of convenience items, (3) income generated by booth sales at conventions and trade shows, (4) income generated by hospital services provided on a cost-plus basis, and (5) income from charitable bingo games.

1. The "Volunteers" Exception

Exempt from UBIT is income from an unrelated trade or business in which substantially all of the work is performed by volunteers.[249] This exception is available only where the voluntary performance of services is a material income-producing factor in carrying on the business, and where substantially all of the services are performed without compensation.[250] For example, the production and sale of recordings by a medical society would be exempt from UBIT where the professional performances are provided without compensation.[251] Similarly, the production and sale of food and other products from farming operations by a religious order would be exempt where the labor was provided without compensation by the members of the order.[252] However, the income from the rental of heavy machinery would not be exempt from UBIT, even though the rental contracts were arranged and payments were processed by volunteers, because the voluntary labor was not a material factor in producing the income.[253]

2. The "Convenience" Exception

Also exempt from UBIT is income from unrelated trades or businesses that are carried on primarily for the convenience of the EO's members, students, patients or employees.[254] This exception would not be available if an unrelated trade or business was carried on primarily to make a profit. Thus, a laundry operated by an exempt university for the purpose of laundering dormitory linens and student clothing would be exempt from UBIT under the "convenience" doctrine. However a laundry operated by an exempt university for the purpose of laundering the clothing of the general public in order to make a profit would not be exempt.[255]

3. The "Convention and Trade Show" Exception

Another exception to UBIT applies to EOs that regularly conduct, as a

249. I.R.C. § 513(a)(1) (1994). *See also,* Rev. Rul. 56-152, 1956-1 C.B. 56.

250. H. Rep. No 2319, 81st Cong., 2d Sess. (1950), *cited by* HOPKINS *supra* note 1, § 40.1 n.n.33.

251. Greene County Medical Soc'y Found. v. United States, 345 F. Supp. 900 (W. D. Mo. 1972).

252. St. Joseph Farms of Indiana Bros. of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner, 85 T.C. 9 (1985).

253. Rev. Rul. 78-144, 1978-1 C.B. 168.

254. I.R.C. § 513(a)(2) (1994). *See also,* Rev. Rul. 69-268, 1969-1 C.B. 160.

255. I.R.C. § 513(a)(2) (1994).

substantial tax-exempt purpose, conventions or trade shows that stimulate interest in, and demand for, the products of a particular industry, or that educate participants about new developments, products, or services that relate to the exempt activities of the organization.[256] The income is excepted from UBIT is that derived from the rental of display space to exhibitors[257] and the provision of supporting services, such as the use of the EO's name, promotion of attendance, planning of exhibits and demonstrations, and provision of lectures.[258]

4. The "Hospital Services" Exception

Income from certain services performed for small hospitals is exempt from UBIT.[259] Services must be provided at a fee which does not exceed cost, including straight-line depreciation and a reasonable rate of return on the capital goods used to provide the service.[260]

5. The "Bingo" Exception

Income from bingo games conducted by EOs is not subject to UBIT.[261] This exception applies only to games not conducted on a commercial basis and not in violation of state or local law.[262] The IRS will contest the exemption if income is derived from players who are not present to place wagers or receive prize distributions.[263]

6. Other Exceptions

Additional specific statutory exceptions to the UBIT include income received by thrift stores from sales of donated clothes and books to the general public,[264] payments received by an EO in return for lending securities to a broker,[265] and income received from the exchange or rental of membership or donor mailing lists to other EOs.[266]

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256. I.R.C. § 513(d)(1) (1994).

257. Treas. Reg. § 1.513-3(d)(1) (1995).

258. Rev. Rul. 78-240, 1978-1 C.B. 170.

259. I.R.C. § 513(e) (1994).

260. The Medicare rules prescribe the method for determining the cost of services and the applicable rate of return. 42 USC 1395x(v)(1)(A),(B) (1994).

261. I.R.C. § 513(f) (1994).

262. H. Rep. No. 95-1608, 95th Cong., 2d Sess. (1978), *cited by* HOPKINS *supra* note 1, § 42.2 n.n.154; *see e.g.*, Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner, 42 T.C.M. 1202 (1981), *aff'd in part and rev'd in part*, 696 F.2d 372 (5th Cir. 1983).

263. Tech. Adv. Mem. 86-02-001 (Feb. 27, 1985).

264. Rev. Rul. 71-581, 1971-2 C.B. 236.

265. I.R.C. § 512(a)(5) (1994).

266. I.R.C. § 513(h)(1)(B) (1994).

F. Application of the UBIT Rules in Special Settings

Certain types of EOs, namely educational institutions, hospitals, and museums, have been traditional targets for UBIT.[267] These EOs are large institutions with many different operations and income sources. The distinctions made over time in the treatment of the various EOs' operations provide a useful model for understanding UBIT.

1. Educational Institutions

An educational institution which operates as an EO is not subject to UBIT for income derived from its basic operations.[268] It will not be taxed on its tuition or dormitory rental revenue derived from its students.[269] Nor will the institution be taxed on the income it receives from admission charges to athletic events.[270]

However, an educational institution that extends its basic operations might be subject to UBIT. Institutions will be taxed for operating travel tour programs that don't include an authentic educational experience,[271] or for providing dormitory facilities to individuals other than its students, particularly where the institution provides collateral services such as meals or maid service.[272]

University bookstore sales are fragmented into their component parts, and, as such, sales of certain items are isolated and subjected to UBIT. Items that are directly related to the institution's educational purpose (e.g., books, classroom supplies, and computer disks) are related and are not subjected to UBIT. In addition, items that are carried for the "convenience" of the students (e.g., health and beauty aids, smoking materials, or items embossed with the university emblem) are not subject to UBIT.[273] However, sales of all other items (e.g., plants and clothing) are subject to UBIT.[274]

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267. HOPKINS, *supra* note 1, § 41.5, at 885-935.

268. H. Rep. No. 2319, 81st Cong., 2d Sess. (1950), at 37, 109; S. Rep. No. 2375, 81st Cong., 2d Sess. 106-07 (1950), *cited by* HOPKINS *supra* note 1, § 40.1 n.n.33.

269. *Id.*

270. *Id.*

271. *Compare* Rev. Rul. 78-43, 1978-1 C.B. 164 with Rev. Rul. 70-543, 1970-2 C.B. 172.

272. The distinctions between permissible and impermissible services is discussed in Rev. Rul. 69-178, 1969-1 C.B.

273. I.R.C. § 513(a)(2) (1994). *See also,* Rev. Rul. 69-268, 1969-1 C.B. 160. This is the "convenience" exception discussed in the text accompanying *supra* note 235.

274. Priv. Ltr. Rul. 80-25-222 (1980). *See generally,* Byron C. Keeling, *Property Taxation of Colleges and Universities; The Dilemma Posed by the Use of Facilities for Purposes Unrelated to Education,* 16 J. OF COLL. & UNIV. L. 623 (1990).

2. Hospitals

In many ways, hospitals are similar to educational organizations in their basic operations. Income derived from patients and businesses that are necessary for patient care are related to the hospital's exempt purpose, and will not be subject to UBIT. Thus, income from gift shops, coffee shops and parking lots will not be taxed so long as they are used by patients, employees, and hospital visitors. In addition, other income derived by hospitals is not taxed. Income from sales of pharmaceutical supplies, provision of necessary diagnostic tests to patients, provision of rehabilitation services to outpatients, and sales of hearing aids as part of the rehabilitation process is not subject to UBIT.[275]

However, income from other activities is more controversial. For example, sales of pharmaceuticals supplies to members of the general public visiting their private physicians in the hospital building may or may not be subjected to UBIT, depending upon the position of the reviewing court. The U.S. Court of Appeals for the Seventh Circuit ruled that such sales were subject to UBIT because the sales were not related to the services provided by the hospital, and were unfairly competitive with commercial pharmacies.[276] The U.S. Court of Appeals for the Fifth Circuit ruled that the pharmaceutical sales were related to the services provided by the hospital because one of the functions of the hospital was to attract physicians to the community and provide facilities to retain them.[277] Testing services provided to members of the general public visiting their private physicians in the hospital building are similarly controversial.[278]

3. Museums

Tax-exempt museums escape UBIT for reasons similar to those described for other educational institutions. Thus, museums are not taxed when they receive income from parking lots, snack bars, and other auxiliary services.

Museum gift shop sales are fragmented in a manner similar to university bookstore sales. However, the distinctions are more refined, and the IRS appears to have developed certain characteristics which trigger a closer look at the applicability of UBIT.[279] In this regard, the IRS is more likely to con-

275. Rev. Rul. 78-435, 1978-2 C.B. 181.

276. Carle Found. v. United States, 611 F.2d 1192 (7th Cir. 1979), *cert. den.*, 449 U.S. 824 (1980).

277. Hi-Plains Hosp. v. United States, 670 F.2d 528 (5th Cir. 1982).

278. *Compare* Rev. Rul. 85-110, 1985-2 C.B. 166 with 85-109, 1985-2 C.B. 165.

279. *See, e.g.*, "Exempt Organizations Annual Technical Review Institute for 1979," Training 3177-01 and 02 (3-79), *cited by* HOPKINS *supra* note 1, § 41.5 n.n.279.

sider that the sales of "luxury" items are an unrelated business, even if those items bear a museum logo.[280] Items that are "adaptations" (rather than "reproductions") of museum displays are closely scrutinized,[281] as are items that are "utilitarian" or "ornamental."[282]

IV. GENERAL ANALYSIS OF UBIT UNDER CURRENT LAW

A. Overview

In recent years, EOs have substantially increased their fund-raising activity. Congress first noted increases in fund raising years ago,[283] and it has accelerated since then.[284] Now, more than ever, EOs engage in a plethora of fund-raising activities because of diminished government funding, economic limitations on private contributions, and an exploding number of nonprofits competing for limited donor dollars.[285]

At the same time that EOs have been trying raise funds to support their operations, Congress has been attempting to raise revenues to fund federal programs. In today's climate of economic reform, EOs are often seen as anti-capitalistic (and therefore anti-democratic) because they compete with tax-paying commercial enterprises.[286] One Philadelphia newspaper recently reported:

> Many nonprofits operate just like for-profit businesses. They make huge profits, pay handsome salaries, build office towers, invest billions of dollars in stocks and bonds, employ lobbyists and use political action committees to influence legislation. And, increasingly, they compete with taxpaying businesses.[287]

The forces impinging upon EOs, private businesses and Congress, have combined to place pressure on exempt status for certain organizations. Even though the statutory changes have been minimal, the rationales and tests traditionally used to impose UBIT are changing. Some rationales and tests are

280. HOPKINS, *supra* note 1, § 41.5, at 896.

281. Murphy, *New Pronouncements from the IRS*, 62 MUSEUM NEWS (No.1) 55 (Oct. 1983), *cited in* HOPKINS *supra* note 1, § 41.5 n.n.281.

282. Gen. Couns. Mem. 38949 (Jan. 6, 1983).

283. Joint Committee, TRA 1969, *supra* note 148 at 66-67.

284. *See, e.g.*, comments on Rep. James H. Bilbray, Chairman, House Subcomm. on Procurement, Taxation and Tourism, Comm. on Small Business, *reprinted in* 94 TAX NOTES TODAY 117-24, June 17, 1994.

285. *Id.* The IRS approved approximately 44,000 new nonprofits during 1993. At the end of 1993 there were 1,110,265 EOS and 527,847 filed information returns with the IRS. *Id.*

286. *See, e.g.*, Gilbert M. Gaul & Neill A. Borowski, *Warehouses of Wealth: The Tax-Free Economy*, PHILADELPHIA INQUIRER, Apr. 18-24, 1993 (series of articles).

287. *Id.*

simply being more strictly enforced, while others are evolving into entirely new standards.

The changing rationales and tests are discussed below in two categories. The first are those changes relating to the "trade or business" requirement. The second are those relating to the "substantially related" requirement.

B. Changing Rationales and Tests

1. The "Trade or Business" Requirement—The Unfair Competition and Commerciality Doctrine and The Profit Motive Test

The three most important rationales and tests for imposing UBIT are Congress' original unfair competition rationale, and the courts' subsequently-developed commerciality doctrine and profit motive test. These three rationales and tests are properly discussed in the context of the first requirement of Treasury Regulation 1.513-1: the "trade or business" requirement.[288]

a. Virtual Disappearance of the Unfair Competition Rationale.

Congress' guiding principle behind UBIT was to eliminate a source of unfair competition.[289] However, the original rationale of unfair competition was seldom used to determine whether UBIT should be imposed. The IRS, the Tax Court, and a majority of the Courts of Appeal imposed UBIT after considering whether the EO was engaged in an "unrelated trade or business which is regularly carried on."[290] The Fifth Circuit Court dismissed the importance of analyzing the unfair competition rationale[291] with these words:

> Although the legislative history speaks of competition, those who actually drafted the statute avoided the word as if it were the plague. . . . [T]he statute and regulations establish a conclusive presumption that the conduct of a trade or business by an exempt organization [not substantially related to exempt functions] constitutes unfair competition against taxable entities engaged in similar activities.[292]

One of the few courts relying upon the unfair competition rationale prior to 1986 was the Seventh Circuit.[293] While holding that UBIT did not apply, the court determined that the existence of unfair competition was "very important in determining whether a given activity is to be taxed as an unrelated trade or business."

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288. *See* HOPKINS, *supra* note 1, § 12.3, at 257-63.

289. See text discussion contained, *supra* part III.A.

290. *See* Treas. Reg. § 1.513-1(b) (1995).

291. Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982).

292. *Id.*

293. Hope School v. U.S., 612 F.2d 298, 302-04 (7th Cir. 1980); *See also,* Carle Found. v.

b. The Emerging Commerciality Doctrine—Is Profit Bad?

Even as Congress' unfair competition rationale was being ignored, the commerciality doctrine was being created. The commerciality doctrine was not created by Congress, but is a body of law engrafted by the courts onto the statutes and regulations.[294] The doctrine involves an activity that is engaged in a "commercial" manner because a for-profit "counterpart" engages in the same activity.[295] One commentator explains the commerciality doctrine as follows:

> When a judge sees an activity being conducted by a member of the business sector and the same activity being conducted by a member of the nonprofit sector, he or she almost always, motivated by some form of intuitive offense at the thought that a nonprofit organization is doing something that "ought to" be done or is being done by a for-profit organization, concludes that the nonprofit organization is conducting that activity in a "commercial" manner. This conclusion then leads to a finding that the "commercial" activity is an "unrelated" activity, with adverse consequences in law for the nonprofit organization, either as respects unrelated income taxation or tax exemption.[296]

To the extent the above-quoted description is valid, the "single most important element of the law of tax-exempt organizations today"[297] is grounded in notions outside of the Internal Revenue Code. In fact, the truth of the description can be verified by chronologically reviewing the case law.

The United States Supreme Court first articulated the commerciality doctrine in 1945.[298] The Court reviewed the tax exempt nature of a chapter of the Better Business Bureau and found that one of the Bureau's purposes was to promote a profitable business community. The Court held that the organization had a "commercial hue" and that its activities were "largely animated by this commercial purpose."[299]

The commerciality doctrine (this time accompanied by its counterpart test) next appeared in a case decided in 1961.[300] An organization published and sold religious literature to further its purpose of upgrading the quality of teaching materials for Bible instruction. It generated "very substantial" prof-

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United States, 611 F.2d 1192, n.6 (7th Cir. 1979), *cert. den.*, 449 U.S. 824 (1980).

294. *See* HOPKINS, *supra* note 1, § 38.1, at 829.

295. *Id.*

296. *Id.* § 38.1, at 830.

297. *Id.* § 38.1, at 829.

298. Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279 (1945).

299. *Id.* at 283-84.

300. Scripture Press Found. v. United States, 285 F.2d 800 (Ct. Cl. 1961), *cert. den.*, 368 U.S. 985 (1962).

its.[301] The court indicated its agreement with the IRS that the existence of "very substantial" profits was "some evidence indicative of a commercial character." The Court applied the counterpart test, stating: "[T]here are many commercial concerns which sell Bibles, scrolls, and other religious and semi-religious literature which have not been granted exemption as to that part of their businesses."[302] The court thus developed a three-part commerciality doctrine consisting of: (1) the scope of an EOs' net profits; (2) the extent of its accumulated surplus; and (3) the amounts expended for tax-exempt functions.

In 1969, the First Circuit established the "rule" that profit is evidence of commerciality. In that case, another publisher of religious literature conducted its operations on a small scale, but in the same manner as any other commercial publisher.[303] To the First Circuit, the fact that the organization's ultimate purpose was religious did not warrant exemption. Rather, the court conferred exemption only because the organization had no profit. The court concluded that "the deficit operation reflects not poor business planning nor ill fortune but rather the fact that profits were not the goal of the operation."[304]

Other cases followed during the 1970s and 1980s, always making the connection between profits and commerciality, most often in the context of religious publications.[305] One of the most interesting and important cases outside of the religious context was *Disabled American Veterans v. United States.*[306] It was an important case because its reasoning was adopted by the Court of Appeals and later became the subject of a pivotal (but ambiguous) U.S. Supreme Court case in 1986[307] The Disabled American Veterans ("D.A.V.") engaged in two income-producing activities which were at issue in the case. First, it offered premiums[308] for persons contributing to D.A.V. as a result of direct mail solicitations. Second, D.A.V. rented its donor list to others at varying prices following the usual trade practice of the direct-mail industry. The court concluded that trading premiums for contributions did not

301. *Id.* at 803.

302. *Id.* at 806, n.11.

303. Elisan Guild, Inc. v. United States, 412 F.2d 121 (1st Cir. 1969).

304. *Id.*

305. *See, e.g.*, Pulpit Resource v. Commissioner, 70 T.C. 594, 611 (1978); Christian Manner Int'l v. Commissioner, 71 T.C. 661 (1979); Inc. Trustees of Gospel Worker Soc'y v. United States, 510 F. Supp. 374, 381 (D.D.C. 1981), *aff'd* 672 F.2d 894 (D.D. Cir. 1981). A few cases made the same connection between profits and commerciality but did not involve religious publications. These include: Washington Research Found. v. Commissioner, 50 T.C.M. (CCH) 1457 (1985) and Junaluska Assembly Hous., Inc. v. Commissioner, 86 T.C. 1114 (1986).

306. 650 F.2d 1178 (Ct. Cl. 1981).

307. See discussion *infra,* part IV.B.1.d.

308. Premiums consisted either of (1) books, maps and charts or (2) wrist calendars. The premiums were comparable to items sold in retail markets.

constitute a trade or business where the contribution required to obtain the premium was double that of the retail value of the premium. The excessive markup negated the trade or business nature of the transaction. However, renting the mailing list did constitute a trade or business because the rates were standard industry rates. In other words, enormous profits were deemed to be non-competitive: where D.A.V.'s donors paid a much higher price for goods than they would have from a commercial enterprise, D.A.V. was not operating a trade or business. By contrast, where profits were in line with those of the industry as a whole, D.A.V. was operating a trade or business.

c. The "Profit Motive" Test

At the same time that some courts were allowing huge profits to be exempt from UBIT under the commerciality doctrine, other courts employed the "profit motive" test to require UBIT where huge profits existed.[309] The "profit motive" test was adopted from IRC section 162 where a business deduction is allowed if an activity " was entered into with the dominant hope and intent of realizing a profit."[310] Adoption of the test from section 162 is validated by Treasury Regulation section 1.513-1(b). The regulation provides: "in general, any activity of [an EO] which is carried on for the production of income and which otherwise possesses the characteristics required to constitute a 'trade or business' within the meaning of section 162" is a trade or business for purposes of sections 511-513.[311]

The "profit motive" test is extremely broad. In endorsing it, one court went so far as to hold that the existence of a profit motive is *the most important* indication of whether an activity is a trade or business. The court stated, "there is no better objective measure of an organization's motive for conducting an activity than the ends it achieves."[312]

To determine whether there is a profit motive, courts look to both subjective and objective factors.[313] In *Professional Insurance Agents of Michigan,*[314] an EO's executive vice-president provided direct evidence of its subjective intent by testifying that an insurance endorsement program would have been discontinued if the program failed to generate income. In *Louisiana Credit Union League v. United States,*[315] the Fifth Circuit held that an EO had

309. S.S. Trade Ass'n of Baltimore, Inc. v. Commissioner, 757 F.2d 1494 (4th Cir. 1985); Carolinas Farm & Power Equip. Dealers Ass'n Inc. v. United States, 699 F.2d 167 (4th Cir. 1983).

310. Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1984).

311. Rabin, *supra* note 28.

312. Carolina Farm & Power Equip. Dealers v. United States, 699 F.2d 167, 170 (4th Cir. 1983).

313. National Water Well Ass'n Inc. v. Commissioner, 92 T.C. 75, 86-87 (1989).

314. 78 T.C. 246 (1982).

315. 693 F.2d 525 (5th Cir. 1982).

a profit motive because, according to the objective evidence, it extensively endorsed and administered a highly profitable program at no risk or expense to itself.

d. The U.S. Supreme Court Attempts Change in 1986

In 1986, the U.S. Supreme Court changed each of the three rationales supporting the "trade or business" requirement.[316] In *American Bar Endowment*, the Supreme Court strongly reaffirmed the importance of the unfair competition rationale, ambiguously cited the profit motive test, and disapproved of the excess profits rationale (along with other rationales used by the lower court) underlying the commerciality doctrine.[317]

The case involved a tax-exempt charitable organization, the American Bar Endowment ("ABE"), which was organized to "advance legal research and promote the administration of justice." ABE generated revenues for its charitable operations by providing group insurance policies to its members. In return, ABE received over forty percent of its members' premium payments. In return for its forty percent, ABE negotiated premium rates with insurers, selected the insurance underwriters, solicited members to purchase the policies, and collected premium payments. The IRS attempted to assess a tax deficiency arising from ABE's failure to report UBIT on the proceeds from the insurance program. The lower courts agreed with ABE using the rationale found in D.A.V.-I: the phenomenal success of the insurance program in generating funds for ABE was found to be evidence of non-commercial behavior. Two additional rationales were used by the lower courts: (1) the program was devised and operated as a means of fundraising; and (2) the ABE members could have voted to return all profits to themselves, but did not. According to the lower courts, the existence of uncommonly large profits, the fundraising intent of ABE, and the potential return of profits to ABE's members meant that the insurance program was not a "trade or business" and that UBIT did not apply.

However, the Supreme Court on review held that the insurance program was a trade or business for purposes of applying UBIT. Most importantly, the Court reaffirmed the importance of the unfair competition rationale by stating:

> The undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed.... This case presents an example of precisely the sort of unfair competition that Congress intended to prevent.... [I]f ABE may escape taxes on its earnings it need not be as profitable as its

316. United States v. Am. Bar Endowment, 477 U.S. 105 (1986).

317. *Id.*

> commercial counterparts in order to receive the same return on its investment. Should a commercial company attempt to displace ABE as the group policy holder, therefore it would be at a decided disadvantage.[318]

In addition to reaffirming the unfair competition rationale, the court cited the profit motive test and discussed its development and use by the circuit courts in a footnote. [319] However, since the profit motive test had not been used below, that test was neither critiqued nor validated.

Finally, the Court noted its disapproval of the way in which the excessive profits rationale was used by the lower courts to support the commerciality doctrine.[320] In the words of the Court:

> We cannot agree with the [lower courts] that the enormous [profits] generated by ABE's insurance program demonstrate that those dividends cannot constitute 'profits.' Were ABE's insurance markedly more expensive than other insurance products available to its members, but ABE nevertheless kept the patronage of those members, we might plausibly conclude that generosity was the reason for the program's success. The [lower courts] did not find, however, that this was the case. ABE prices its insurance to remain competitive with the rest of the market. [citation omitted]. Thus, ABE's members never squarely face the decision whether to support ABE or to reduce their own insurance costs.

If the Supreme Court's statements had been clear, no questions about applying the "trade or business" requirement to UBIT would remain after *American Bar Endowment.* However, as discussed below, debate over the importance of unfair competition and the relative values of the commerciality doctrine and the profit motive test is still very much alive.

e. Inconsistent Applications of American Bar Endowment

The Supreme Court's decision clarifying the "trade or business" requirement for UBIT has been inconsistently applied by appellate courts. After *American Bar Endowment*, most courts continued to emphasize the "profit motive" test even though the Supreme court had neither critiqued nor validated it.

The U.S. Court of Appeals for the Seventh Circuit emphasized the "profit motive" test by finding that the presence or absence of the risk of unfair competition was not critical. In *Fraternal Order of Police, Illinois State Troopers Lodge No. 41 v. Commissioner*,[321] the Seventh Circuit stated:

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318. *Id.* at 114-15.

319. *Id.* at n.1.

320. *Id.* at 111 (*citing* Professional Ins. Agents of Michigan v. Commissioner and Carolinas Farm & Power Equip., *supra* note 312.

321. 833 F.2d 717 (7th Cir. 1987).

> No court has yet created a general exception to the unrelated business income tax based solely on a showing that the tax-exempt organization did not compete, or threaten to compete unfairly with taxpaying entities. Rather, the cases hold that activities engaged in for the production of income do not constitute a "trade or business" within the meaning of [§] 513(c) where the income is derived from charitable contributions rather than from the sale of goods or the performance of services.

Under the facts of the case, the court determined that the journal published by the Fraternal Order of Police was identical to another magazine published for profit. The court imposed UBIT under the "profit motive" test. The D.C. Circuit ruled similarly in a case where the EO's activity was provided by commercial entities.[322]

In addition, despite the fact that the Supreme Court refuted the rationales underlying the commerciality doctrine, the doctrine is still being raised by commentators[323] and by Congress.[324] Furthermore, the Seventh Circuit recently affirmed the use of several factors specifically indicative of "commerciality."[325] The factors include: (1) the sales of goods or services in competition with commercial firms; (2) the use of pricing formulas, promotional materials, and advertising similar to those of commercial entities; and (3) work provided by employees with business experience rather than volunteers.[326]

2. The "Substantially Related" Requirement

a. Historical Perspective

As discussed previously, since Congress implemented UBIT in 1950, one of the three standard requirements for its imposition has been the "substantially related" requirement. UBIT is imposed unless a trade or business activity substantially relates to one or more of the EO's exempt purposes.[327] A trade or business activity meets the substantial relationship requirement only if it "contributes importantly" to the accomplishment of an EO's exempt purpose(s).[328] The fact that the income from the activity is destined to support the EO's exempt purposes is irrelevant. Instead, the important consideration

322. American Postal Workers Union, AFL-CIO v. U.S., 925 F.2d 480, 482-83 (D.C. Cir. 1991).

323. *See, e.g.*, HOPKINS, *supra* note 1, § 38.2, at 841 and Trevor A. Brown, *Religious Nonprofits and the Commercial Manner Test*, 99 YALE L.J. 1631 (1990).

324. The Tax Reform Act of 1986 prohibited an EO from providing "commercial-type insurance."

325. Living Faith v. Commissioner, 950 F.2d 365, 370 (7th Cir. 1991), *aff'g* 60 TCM 710 (1990).

326. *Id.*

327. Treas. Reg. § 1.1513-1(a) (1995).

328. Treas. Reg. § 1.513(d)(2) (1995).

is the activity itself, or the source of income.

A complicating factor occurred in 1967, however, when the Treasury promulgated the "fragmentation rule."[329] While the rule was adopted under the "trade or business" requirement, it also affected the "substantially related" requirement. Under the new rule, each fragment of a trade or business activity had to contribute importantly to the EO's exempt purpose in order to avoid UBIT. If only one portion of an activity related to the EO's exempt purpose, it did not exempt other portions from UBIT.

However, a problem developed with the way in which the Treasury illustrated the application of the "fragmentation rule" to the substantial relationship requirement. Example 7 of Regulation 1.513-1(d)(4) involved an EO which was formed to advance the interests of a particular profession.[330] The EO in the Example published a monthly journal containing editorial materials and advertising. The editorials were substantially related to the EO's exempt purpose, but the advertising, selected in the manner of ordinary commercial activities, did not. UBIT was therefore imposed on the advertising income. However, Example 7 failed to clarify the legal consequence of advertising which was substantially related to an EO's exempt purpose.

b. The Supreme Court Clarifies the "Substantially Related" Requirement in 1986

In 1986, the U.S. Supreme Court clarified the Regulation's Example 7. In *U.S. v. American College of Physicians*,[331] the American College of Physicians existed to maintain high standards in medical education and medical practice, to foster measures to prevent disease, and to improve public health. In furtherance of its exempt purposes, the EO published the Annals of Internal Medicine, a highly-regarded monthly medical journal containing scholarly articles. The journal accepted for each issue advertising containing medical information about the use of medical products. The IRS contended that Example 7 created a per se rule taxing advertising income. Under this interpretation, the EO's net proceeds would be subject to UBIT. The EO, on the other hand, contended that Example 7 was intended to require that advertising conform only to the substantial relationship test. That is, if all of the advertising activity contributed importantly to the EO's exempt purposes, no UBIT would be imposed. The EO contended that in this case, all of its advertising did conform to the substantial relationship test because the advertising disseminated valuable information about medical advancements to the EO's journal subscribers and helped to advance its exempt educational and medi-

329. See discussion of Treas. Reg. § 1.513-1(b) (1995) contained in part III.C. 1.

330. Example 7 is found in Treas. Reg. § 1.513-1(d)(4)(iv) (1995).

331. 475 U.S. 834 (1986).

cal care purposes.

The Supreme Court first determined that Example 7 did not create a per se rule requiring taxation of advertising income. However, the Supreme Court did not entirely agree with the EO because it next determined that the intellectual impact of the advertising upon member subscribers was irrelevant. Only the conduct of the EO was important. Even if the EO's members gained valuable information from the advertising, the effect on the members was not relevant. Since the EO did not systematically or comprehensively design the advertising to educate its readers or to fulfill the EO's other exempt purposes, the advertising was not related to those purposes. The Court stated:

> [We] are bound to conclude that advertising in Annals does not contribute importantly to the journal's educational purposes. This is not to say that the college could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the [EO] could satisfy the stringent standards erected by Congress and the Treasury.[332]

This statement reflects the most important result of *U.S. v. American College of Physicians*.[333] The Supreme Court attempted to focus the "substantially related" analysis on the *manner* in which an EO's fund-raising activity is conducted as opposed to the *outcome* of that activity.

c. Inconsistent Applications of U.S. v. American College of Physicians

As with the "trade or business" requirement, application of the principles set forth in *U.S. v. American College of Physicians* has been inconsistent. Of the three appellate court decisions specifically dealing with the "substantially related" requirement, only one followed the Supreme Court in focusing on the manner in which the activity was conducted.

In *Illinois Association of Professional Insurance Agents, Inc. v. Commissioner*,[334] the Seventh Circuit asked the crucial question required by *American College of Physicians*. In determining whether fee income was taxable if it was received in return for performing promotional and administrative services in connection with the sale of insurance, the court appropriately found that:

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332. *Id.*

333. *See e.g.*, Matthew A. Aiken, Note, *Insurance Trade Association Held Subject to Unrelated Business Income Tax:* Indef. Ins. Agents of Huntsville, Inc. V. Commissioner, 47 TAX LAW. 815-25 (1994).

334. 801 F.2d 987 (7th Cir. 1986).

> [The EO] did not merely inform its members of the general need for [insurance] coverage through its publications. Nor did it provide coverage where none was available in the market. . . . Rather, [the EO] endorsed a particular [insurance] program in *a manner* which provided convenient marketing, advertising and administrative services to the offering insurance company, generated income for the Association, and provided its individual members convenient coverage. (emphasis added).[335]

By contrast, the Fifth Circuit in *Texas Apartment Association v. United States*[336] all but ignored the language of *American College of Physicians*. The court used a two-prong test for determining whether the EO's activities and purposes were "substantially related:" (1) the activity was "unique" to the organization's exempt purposes; and (2) the direct benefits of the activities flowed to the EO's members. The Fifth Circuit denied the application of UBIT, but its' analysis bore no resemblance to that of the Supreme Court.

The most recent case was issued by the Eleventh Circuit. In *Independent Insurance Agents of Huntsville, Inc. v. Commissioner*,[337] the Eleventh Circuit affirmed the Tax Court's decision that commissions earned by a tax-exempt trade association from providing insurance for public agencies were subject to UBIT because the activity generating those commissions was not "substantially related" to the EO's exempt purposes. Although the court purported to focus on the manner in which the EO's activity was conducted,[338] the court actually focused on the end results, precisely in contrast to the requirements of *American College of Physicians*.[339]

3. Other Changes

Two rationales or tests for imposing UBIT are evolving. However, these rationales and tests have not yet become the subject of inconsistent appellate court decisions. Developments relating to the "commensurate" test and the "primary purpose" rule are discussed separately in this subsection.

a. New Life For The Commensurate Test

The commensurate test is becoming more important test in determining whether UBIT should be imposed. It was first articulated by the IRS in 1964.[340] The test requires that a charitable organization maintain program activities that are commensurate in scope with its financial resources. In the 1964 Revenue Ruling, the IRS agreed that an organization could retain its tax

335. *Id.* at 995.

336. 869 F.2d 884 (5th Cir. 1989).

337. 998 F.2d 898 (11th cir. 1993).

338. *Id.* at 901 (*citing* United States v. Am. College of Physicians, *supra* note 331).

339. *See also*, Aiken, *supra* note 333.

340. Rev. Rul. 64-182, 1964-1 C.B. (Part 1) 186.

exempt status even though it derived most of its income from rents because it engaged in adequate charitable functions.

The commensurate test, which is somewhat related to the operational test,[341] resurfaced in 1990 when the IRS began a close review of the fund-raising practices of charitable organizations. At that time, the IRS asked its auditing agents to determine whether charitable organizations meet the "commensurate" test through the use of the audit check sheet entitled "Exempt Organizations Charitable Solicitations Compliance Improvement Program Study Check sheet."[342] The IRS reviewing agent is required to determine whether the charitable organization is engaging in sufficient charitable activity relative to its available resources, including gifts received through fund-raising campaigns as measured against the time and expense of fund-raising.

In 1990, the IRS also used an organization's failure to pass the commensurate test as one of the reasons to revoke its tax-exempt status.[343] The IRS concluded that the commensurate test was violated because the organization involved expended only about four percent of its revenue for charitable purposes over a two-year period. The remaining ninety-six percent of its revenue was allegedly spent for fund-raising and administration. The IRS stated:

> The "commensurate test" does not lend itself to a rigid numerical distribution formula—there is no fixed percentage of income that an organization must pay out for charitable purposes. The financial resources of any organization may be affected by such factors as start-up costs, etc. In each case, therefore, the particular facts and circumstances of the organization must be considered. Accordingly, a specific payout percentage does not automatically mandate the conclusion that the organization under consideration has a primary purpose that is not charitable. In each case, it should be ascertained whether the failure to make real and substantial contributions for charitable purposes is due to reasonable cause.
>
> .... While there is no specified payout percentage, and while special facts and circumstances may control the conclusion, distribution levels that are low invite close scrutiny. The "commensurate test" requires that organizations have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial. Therefore an organization that raises funds for charitable purposes but consistently uses virtually all its income for administrative and promotional expenses with little or no direct charitable accomplishments

341. See discussion part II.C.1.b.

342. *See* BRUCE R. HOPKINS, THE LAW OF FUND-RAISING 368 (1991).

343. Unpublished technical advice memorandum, *reprinted in* 4 EXEMPT ORG. TAX REV. 726 (July 1991).

cannot reasonably argue that its charitable program is commensurate with its financial resources and capabilities.[344]

b. The Declining Importance of the "Primary Purpose" Rule

The harsh nature of the traditional "primary purpose" rule is exemplified by the U.S. Supreme Court's statement in *Better Business Bureau of Washington, D.C. v. United States*:[345] "the presence of a single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly. . . [exempt] purposes." The Eighth Circuit slightly eased the harshness of this rule in 1967.[346] It held that nonexempt activity would not result in loss or denial of exemption where it was "only incidental and less than substantial."[347]

The "primary purpose" rule has further declined in importance. The decline is exemplified by a federal court case where a public parking facility retained its status as a charitable organization.[348] The organization was formed by several private businesses and professional persons to construct and operate a parking facility. The purpose of the facility was to attract shoppers to a city center and a validation stamp system was used to encourage patronage to the founders' shops. The district court concluded that the city was the primary beneficiary of the store owners' efforts, stating "[the] business activity itself is similar to that which others engage in for profit but it is not carried on in the same manner; it is carried on only because it is necessary for the attainment of an undeniably public end."[349]

Even though the IRS does not officially subscribe to this relaxed position,[350] in the area of health care it has viewed seemingly private purposes as being for public benefit in the long run.[351] Where an organization was formed to attract a physician to a medically under served rural area and provided the doctor with a building and facilities at a reasonable rent, the IRS stated that "any personal benefit derived by the physician (the use of the building in which to practice medicine) does not detract from the public purpose of the organization nor lessen the public benefit flowing from its activities."[352]

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344. The organization is still contesting its tax exempt status in United Cancer Council, Inc. v. Commissioner 100 T.C. 162 (1993).

345. 326 U.S. 279, 283 (1945).

346. *See* St. Louis Union Trust Co. v. United States, 374 F.2d 427, 431-32 (8th Cir. 1967).

347. *See supra,* part II.C.1.d.

348. Monterey Pub. Parking Corp. v. United States, 321 F. Supp. 972 (N.D. Cal) *aff'd* 481 F.2d 175 (9th Cir. 1973).

349. *Id.* at 977.

350. Rev. Rul. 77-111, 1977-1 C.B. 144.

351. Rev. Rul. 73-313, 1973-2 C.B. 174.

352. *Id.*

V. PRINCIPLED ARGUMENTS TO AVOID THE IMPOSITION OF UBIT

In light of the uncertainty surrounding two of the three components of UBIT, it is essential for EOs to understand the legal principles discussed herein and the strengths and weaknesses of those principles. EOs may be the only entities capable of, or interested in, opposing ubiquitous UBIT. To date, their efforts have been inadequate. As one commentator states: "The nonprofit community has not been quick to respond with a convincing rationale for the continuation of tax exemptions. This has been particularly the case with respect to charitable organizations [citations omitted] and the competition issue."[353] If EOs do not provide the principled arguments to avoid the logical fallacies in the current case law, no one else will.

From these authors' perspectives, the largest threat to EOs is the widespread use of the "profit motive" test. This test is used most often by the appellate courts to decide whether a fund-raising activity is a "trade or business." If the test continues to develop as it has, it will threaten all EOs' profitable fundraising efforts and disregard only those with negative cash flows.

Fortunately, however, the "profit motive" test should be easy to refute. It was never specifically sanctioned by the U.S. Supreme Court and it contains some logical flaws. Furthermore, the prevalent use of the "profit motive" test is based upon an incomplete evaluation of the policies underlying UBIT. Congress never intended that EOs eliminate all profitable activities. As the Supreme Court stated in *American College of Physicians:*

> Congress did *not force exempt organizations to abandon all commercial ventures*, nor did it levy a tax only upon businesses that bore no relation at all to the tax-exempt purposes of an organization, as some of the 1950 Act's proponents had suggested [citations omitted]. Rather, in the 1950 Act it struck a balance between its two objectives of encouraging benevolent enterprise and restraining unfair competition by imposing a tax on the "unrelated business taxable income" of tax exempt organizations.[354] (emphasis added).

Most certainly, Congress did not decide to tax activities simply because they are profitable. EOs must make this argument forcefully.

EOs are further threatened by the fact that commentators and the courts do not always analyze the correct issues in context. When such misguided analysis occurs, even favorable case law becomes less useful. For example, one statement by the Fifth Circuit should provide excellent ammunition to refute the worst parts of the "profit motive" test. In *Texas Apartment Asso-*

353. *See* HOPKINS, *supra* note 1, § 4.2, at 57.

354. 475 U.S. 834 (1986).

ciation v. U.S.,[355] the court ridiculed the IRS for arguing that an EO should have given its product away instead of selling it for a profit. Unfortunately, the court did so in the context of the "substantially related" analysis rather than the "trade or business" analysis. This flaw allows the reasoning to be attacked, and perhaps ignored, by those who don't thoroughly understand UBIT's regulations and underlying rationale.

VI. STRENGTHENING EXEMPT STATUS AND AVOIDING UNNECESSARY UBIT

Before the IRS exacts UBIT, there is much an EO can do to strengthen its position. First, EOs should review their mission statements annually. Since the mission statement contains the exempt purposes, annual review will allow the EO to shape its activities to contribute substantially to its goals. If the original scope of the mission statement is no longer valid, the statement should be modified or a new one created in accord with the organizational rules discussed in section II.

Second, an EO should review its activities to determine if they contribute to its exempt purposes. Criteria for determining the way in which activities contribute to exempt purposes should be established. Although a few unrelated activities are allowed under the primary purpose rule, establishing such criteria will focus the EO's efforts.

Activities which meet the established criteria should then be recorded along with the revenues and costs associated with them. Even activities that are generated by joint ventures with other EOs should be recorded and analyzed. The records should be supported by time sheets and job descriptions. Furthermore, the time sheets and job descriptions should be tied directly to workpapers which show a consistent method of allocating resources to different types of activities.

Each EO should identify potential conflicts of interests. All salaries and benefits provided should be compared with other institutions to determine their reasonableness. All loans should be demonstrably advantageous to the organization.

By taking these actions, EOs can strengthen their exempt status to avoid unnecessary UBIT.

355. 869 F.2d 884 (5th Cir. 1989).