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# LEGAL FRAMEWORK FOR EARNED INCOME

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# AGENDA

I. Introduction and hypothetical problem.

II. When is earned-income tax-exempt?

III. When is earned-income taxable?

IV. When does too much taxable income jeopardize tax-exempt status?

V. Strategies for dealing with too much taxable, earned-income.

# I. INTRODUCTION

This paper discusses issues that are relevant for a nonprofit corporation (in any state) that is tax-exempt under Internal Revenue Code ("Code") Section 501(c)(3) and that is a public charity described in Code Section 509. In this paper, I refer to this organization as the "Charity."

Entirely different rules apply for taxable entities. Somewhat different rules apply for Section 501(c)(3) private foundations, and slightly different rules apply for 501(c)(3) public charities that are organized in trust, rather than corporate, form.

***The Hypo:***

Throughout this paper, I will refer to the following, very typical, hypothetical situation involving a Charity hoping to generate some additional earned income:

> Ms. Smith is the Executive Director or Chief Executive Officer of Charity. Charity has two lines of activity: (1) it operates a restaurant staffed by low-income, formerly homeless persons to provide job training and also a fine meal; and (2) it provides consulting services to other nonprofit organizations that are operating job training or similar businesses. Charity currently provides these services at well-below cost.
>
> Ms. Smith sees an opportunity to use the skills and knowledge that Charity has developed to generate income in support of its two programs. Ms. Smith is considering having Charity open another restaurant that would not provide job training, but that would be staffed by professional wait persons. Ms. Smith is also interested in providing above cost, but below market value consulting services to larger nonprofits.

***Questions:***

In order to help Ms. Smith, we need to explore a series of logically related issues:

1. We need to confirm that the current programs of Charity are consistent with its tax-exempt purposes and do not generate taxable income.

2. We need to explore whether the proposed activities would be consistent with Charity's tax-exempt purposes.

3. If the proposed activities are not consistent with Charity's tax-exempt purposes, we need to analyze whether income from the activities will be taxable as unrelated business taxable income ("UBTI").

4. We need to consider whether Charity will engage in sufficient non-exempt activities to jeopardize its tax-exempt status.

5. If Charity might jeopardize its tax-exempt status, then we need to consider alternative strategies to permit Charity to engage in these new activities.

## II. WHEN IS EARNED-INCOME TAX-EXEMPT?

An organization that is tax-exempt under Section 501(c)(3) does not normally pay taxes on its income, whether that income is donated, investment income, or earned income from providing services or selling goods.

Charity was recognized by the IRS as tax-exempt. Does it still qualify? In order to qualify for exemption under Section 501(c)(3), and in order to maintain tax exempt status, Charity must be organized and operated for one or more of the exempt purposes listed in Section 501(c)(3), and it must refrain from private inurement, electioneering, and substantial lobbying.

Assuming that Charity's Articles of Incorporation or Certificate of Incorporation continue to contain all the necessary 501(c)(3) required language, Charity will continue to be "organized" for tax-exempt purposes.

If we assume, for purposes of our hypothetical that Charity is not interested in lobbying, political activity, or any private benefit, private inurnment, or excess benefit transactions, we are left with a single question: does Charity continue to be "operated" for one or more tax-exempt purposes.

It is important to note that Code Section 501(c)(3), taken literally, requires an organization to be operated *exclusively* for exempt purposes. The Regulations, however, add some flexibility to what is known as the operational test. They make clear that a charity may qualify as such if it is operated *primarily* for exempt purposes. An "insubstantial part" of the charity's activity may be devoted to non-exempt purposes.[1] Thus, a charity may operate a trade or business whose conduct is not related to the achievement of its exempt purposes without losing its charitable status under the tax law.

What makes the operational test especially challenging is that there is no single legal standard for whether an activity is consistent with Section 501(c)(3)'s operational test. The law has evolved different rules and different tests for different types of activities, particularly revenue generating activities. In analyzing whether an income-generating activity is an appropriate exempt activity, the IRS and courts have examined a variety of factors, many of which ultimately result in a smell test: Does the activity in question smell more like a commercial or an exempt activity? As the United State District Court recently said, does the activity have a "commercial hue"? (*Airlie Foundation v. IRS*, 283 F.Supp. 2d. 58 (D.D.C 2003)).

Charity currently engages in job training through the operation of a restaurant and consulting for nonprofits at a fee that is well-below cost. Let us examine each of these areas separately.

***Job Training.*** The Treasury Regulations tell us that the term "charitable," as used in Section 501(c)(3) in its generally accepted legal sense, can include activities that might also be described as educational, religious, or scientific. The term "charitable" includes: relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of

[1] Reg. Sec. 1.501.(c)(3)-1(c)(1).

education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes or to: (i) lessen neighborhood tensions; (ii) eliminate prejudice and discrimination; (iii) defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

The IRS recognizes helping a disadvantaged class of individuals learn a job skill, even through the operation of what would otherwise be a commercial business (such as a restaurant) is an exempt activity. The disadvantaged class could be based on poverty, a physical or mental disability, and other factors.

In *Aid to Artisans, Inc. v. Commissioner*, 71 T. C. 202 (1978), the U.S. Tax Court considered the exemption of a charity that purchased and sold handicrafts from disadvantaged craftspeople. The charity in that case sold the handicrafts to museums and other nonprofit shops and agencies. The Tax Court found that the sale of these items was related to the exempt purpose of the organization because the activity alleviated economic deficiencies in communities of disadvantaged artisans, and the crafts themselves served to educate the public in the artistry, history, and cultural significance of handicrafts from these communities. A similar conclusion was reached in *Industrial Aid for the Blind v. Commissioner*, 73 T.C. 96 (1979), in which the corporation purchased products manufactured by blind individuals and sold them to various purchasers.

In Rev. Rul. 73-128, 1973-1 (1973), the IRS determined that a business conducted for the primary purpose of providing skills training to the disadvantaged was operated for charitable purposes. In Rev. Rul. 75-472, 1975-2 C.B. 208 (1975), a charity directly employed disadvantaged persons in its business. That business involved the production and sale of furniture made by residents of the corporation's halfway house for alcoholics. We see modern-day examples of this type of program in the Bay Area today with Delancey Street, Juma Ventures, and Pedal Revolution, to name a few.

Charity's current operation of a restaurant staffed by low-income homeless fits squarely within the accepted rulings on tax-exempt job training programs.

Similarly, it is clear that operation of a restaurant that is staffed by professional waiters would not be consistent with Charity's exempt purpose. As we will see below, such an activity would generate unrelated business income, and if sufficient enough in size and scope, might jeopardize the Charity's exempt activity.

***Fee-Based Management and Consulting Services.*** A charity may develop expertise in an area as a result of its charitable work. For example, a low-income housing organization may develop expertise in the management of real estate, or a nonprofit management center may develop expertise in counseling charities on fundraising, governance, and management issues. When can such an organization offer these services on a fee-for-service basis, consistent with the organization's tax exemption?

For an excellent article on this subject, see *Management and Consulting Services: The Impact on Exempt Status and UBIT*, by Loren D. Prescott, Jr., The Exempt Organization Tax Review, Vol. 42, No. 2, page 209 (November 2003). In this article, Professor Prescott indicates

that courts and the IRS will look at a series of factors in evaluating whether an activity is consistent with a charity's exempt purpose, and we use these factors for purposes of analyzing the issue in this paper:

- The relationship of the service provider to the recipient.
- Whether the fee charged is substantially below the charity's cost of providing the service; in other words, whether the charity looks to charitable contributions to support the activity or whether it is self-supporting.
- The nature of the services provided. How commercial seeming are the services?
- Who are the recipients of the services – other nonprofits and/or others?

The relationship of the service provider to the recipient – the Integral Part Test. A charity can provide services to certain legally related or commonly controlled organizations consistently with its exemption. For example, three hospitals that are part of a common nonprofit hospital chain might establish a new charity whose sole purpose is to provide administrative support to each of the hospitals on a fee-for-service basis. Under the "integral part" test, this organization is easily exempt.[2]

The IRS recognizes that where the activities of an organization bear a close and intimate relationship to the functioning of one or more charities, and the service provider is engaged in services that are necessary and indispensable to the operations of the charities, the organization will take on the tax-exempt status of the charities receiving the services.[3] If the service provider engages in other exempt activities, so that the issue is not one of losing exemption but of incurring UBTI, the same analysis applies; i.e., if the service activities can be shown to be an integral part of the recipient charity's exempt activities, they will not be treated as an unrelated trade or business and thus will not generate UBTI.[4]

Section 1.502-1(b) of the Regulations imposes requirements regarding the control relationship between the service provider and the charities receiving its services. In addition, the

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[2] *See* Code Section 502 and accompanying regulations; *HCSC-Laundry v. United States*, 450 U.S. 1 (1981) (although this case is specific to a cooperative hospital service organization); *Geisinger Health Plan v. Commr.*, 100 T.C. 394 (1993), *aff'd* 20 F.3d 494 (3rd Cir. 1994) articulates the test.

[3] *See, e.g., Squire v. Students Book Corp.*, 191 F.2d 1018, 1020 (9th Cir. 1951) (recognizing corporation that operated a college book store as tax-exempt because, among other things, its business enterprise bore a close and intimate relationship to the functioning of the college). Similarly, the Section 502 Regulations acknowledge that a service provider may be exempt because it functions as an integral part of another charity. This principle is illustrated by the example of a subsidiary organization operated for the sole purpose of furnishing electric power used by its exempt parent in carrying out the parent's exempt function, in which case the subsidiary would be recognized as exempt. The integral part analysis can be applied to other tax-exempt entities in addition to charities exempt under Section 501(c)(3), and Section 502 applies more generally to entities exempt under Section 501. However, for purposes of this discussion, we only discuss the integral part test in connection with Section 501(c)(3) service providers and recipients.

[4] *See*, for example, UBIT analysis in PLR 9617031.

Section also requires sufficient relatedness among the organizations receiving services from the organization seeking tax-exempt status. The Section specifies that organizations are related only if they consist of (i) a parent organization and one or more of its subsidiary organizations, or (ii) subsidiary organizations having a common parent organization. In General Counsel Memorandum 39,874, the IRS stated that under Reg. Sec. 1.502-1(b), the organization seeking tax-exempt status, and all organizations receiving benefits from that organization, must be structurally related in relationships substantially similar to that of a subsidiary and parent or subsidiaries of a common parent in order to qualify.

The IRS recognizes that most charities are nonstock entities, making it difficult to apply technical parent-subsidiary tests. In Revenue Ruling 68-26, the IRS found that even though a technical parent-subsidiary relationship may not exist, a parent-subsidiary relationship can be present if "a substantially similar relationship does in fact exist through the control and close supervision of its affairs."

Furthermore, in some rulings the IRS has appeared to be somewhat flexible about the relationship test between the recipients of the services. In Revenue Ruling 75-282, an organization formed and controlled by an exempt conference of churches made mortgage loans of less than the commercial rate of interest to churches that were members of the conference. It was held to be operating under the close supervision and control of the parent church conference, was considered to be carrying out an integral part of the activities of the parent (aiding churches in obtaining facilities), and was recognized as exempt. However, the IRS does not clarify the exact relationship between member churches and the conference of churches. In Private Letter Ruling 9617031, five charities were outgrowths of Y, an exempt domestic fraternal society. The five charities were member organizations. Current and former directors, officers, and/or members of Y were involved in selecting the boards of the five charities, but no direct control relationship existed. Y supported the charities by coordinating many of their fundraising, program service and administrative activities. Y planned to charge for support services provided to the charities at the lower of cost or fair market value. The IRS found that Y's performance of the services for charitable organizations unrelated to itself would constitute an unrelated trade or business. However, the IRS found that in this case Y and the charities were related within the meaning of the 502 Regulations, even though in this ruling Y, the service provider, was itself the "parent" organization, and the charities did not appear to be directly controlled by Y.[5]

Whether the fee charged is substantially below the charity's cost of providing the service. In cases in which the integral part doctrine does not apply, the IRS seems to focus primarily on this factor. If the fee charged is substantially below the Charity's cost and the activity is

[5] *See also* PLR 9849027, in which the service provider ("A") was a graduate educational institution that operated a college and provided central programs to a group of colleges, including A, that coordinated their operations. Each college was a separate legal entity, but the colleges were located around a common library and other facilities and shared many programs. The group had a constitution setting out the legal relationship among the colleges. It provided that each college was represented on the Board of Fellows that governed A. Whenever a Board of Fellows vote affected a member of the group other than A or one of the central programs carried on by A, an affirmative vote of at least two-thirds of the members could be required. The presidents of all the colleges approved the budget for A's central programs. Many intercollegiate committees existed to coordinate activities. The IRS found that the colleges had enough control over A through the Board of Fellows to satisfy the control and close supervision required by Rev. Rul. 68-28. The IRS did not specifically address the relationship among the colleges receiving the services, but they did not appear to be subsidiaries of a common parent.

subsidized by charitable contributions, the charity can successfully argue that the activity furthers its exempt purpose. "Substantially below cost" is not defined, but rulings suggest that 75% of cost or even 85% of cost may be sufficient. Revenue Ruling 71-529 says that 15% below cost is acceptable. In PLR 9347036, the IRS seems to say 10% below cost is also feasible. This means that it is difficult for a charity to sell services, even below market but above cost and have those services considered as part of its exempt activity.

The IRS developed the "substantially below cost" analysis in two Revenue Rulings. In Revenue Ruling 71-529, an organization was formed to aid other charities by assisting them in managing their endowment or investment funds more effectively. The member organizations paid only a nominal fee for these services; the organization's operating expenses were primarily paid by grants from independent charitable organizations. The fees for the services represented less than 15% of the total costs of operation. The IRS found that the entity was exempt given that it performed an essential function at substantially below cost. In Revenue Ruling 72-369, an organization provided managerial and consulting services to charities to improve the administration of their charitable programs. The organization entered into agreements with unrelated charities to furnish the services on a cost basis. The IRS found that furnishing these services on a cost basis did not constitute a charitable activity, because the organization lacked the donative element necessary to establish the activity as charitable.

A key factor in showing that services are being offered at substantially below cost is to show that the service provider raises funds from other independent charities or other donors, as in Rev. Rul. 71-529, to subsidize the services. In effect, the service provider is making a grant, in the form of donated services, to the service recipient.

*BSW Group, Inc. v. Commr.*, 70 T.C. 352 (1978), is the leading case. In that case, a charity provided consulting services to a small number of organizations for a fee. The Court found that even though the fee was below market, it was above cost and, therefore, was not sufficient to establish the charitable nature. See also Private Letter Rulings 200036049, 200332046, and 9414003 as other examples citing *BSW*. The IRS and the Tax Court recently confirmed this line of thinking in *At Cost Services v. Commr*. 80 TCM 573 (2000), where job training and placement fees equal to cost were not considered to be charitable. See also TAM 9232003 (management for a fee equal to cost plus a percentage of management fee is not charitable).

<u>The nature and scope of the services – the presence of competition.</u> Both for purposes of analyzing the extent to which an activity is too commercial to be consistent with exempt purposes and for purposes of assessing UBIT, the IRS and courts look to the type of services and the commercial hue of the services. Neither the courts nor the IRS regard the mere existence of competition as determinative of the tax treatment of a particular activity.

While competition with for-profit entities is not a determinative factor, the presence of for-profit entities engaging in similar services is one factor used by the courts and the IRS to assess whether or not an activity furthers the charitable purposes of an organization. See, e.g., *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352 (consulting services provided primarily to other charities in the area of rural-related policy and program development were of the sort ordinarily carried out by commercial businesses such as banks, personnel agencies, and trash disposal firms; court found that competition with commercial firms is strong evidence of the

predominance of nonexempt commercial purposes); Rev. Rul. 69-528 (providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for profit); Rev. Rul. 72-369 (providing managerial and consulting services to charities to improve their administration for a fee intended to recover costs is a trade or business ordinarily carried on for profit).

On the other hand, if a charity can differentiate its services from those offered by for-profit providers, it strengthens its claim that its services are related to its exempt purposes. See Rev. Rul. 69-572 (charity created to construct and maintain a building to house member agencies of a community chest is distinguishable from for-profit landlord because, among other things, the charity offered a large central meeting room for free use of the lessees and other interested community chest agencies; providing housing for a number of member agencies at one convenient central place enabled the agencies to make frequent use of volunteer labor on a efficient basis; and there was a close connection between the charity and the charitable functions of the tenant organizations); PLR 9347033[6] (a charity operating as a community foundation and also providing grant-making services to other charities for a fee intended to recover costs was engaging in related activity; its grant-making services could be distinguished from services that are commercial in nature, such as management consulting, accounting, bookkeeping, and legal services).[7]

Instead of basing a conclusion solely on competition with for-profit entities, a more careful analysis of the size and extent of the activities in relation to the nature and extent of the exempt function that they purport to serve is important in determining relatedness. If the organization conducts the activity on a scale larger than reasonably necessary for the performance of exempt functions, the excess may be treated as unrelated to accomplishing an exempt purpose or function.[8] For example, in Revenue Ruling 57-313, an organization that conducted and supported medical and scientific research also operated a medical illustration department and an electroencephalography clinic for its own use, as well as for the use of hospitals and other medical and educational organizations. The Service ruled that those activities were unrelated trades or businesses because they were conducted in a manner disproportionate when compared with the size and extent of the organization's other activities.

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[6] While private letter rulings do not constitute precedential authority, we cite them here as an example of the IRS' analysis of these issues.

[7] The grant-making services included: (i) coordination and response to all inquiries related to a particular organization's grant-making activities; (ii) provision to potential applicant/donees of the particular organization's grant-making guidelines; (iii) communication with potential applicants/donees regarding the status of applications and funding proposals; (iv) conduct of site visits, interviews, or other pre-grant inquiries necessary to obtain information to evaluate funding proposals; (v) creation of proposal screening and evaluation processes; (vi) presentation of grant-making recommendations to a particular organization; and (vii) assessment of grant impact.

[8] Reg. § 1.513-1(d)(3*)*; Tech. Adv. Mem. 9636001 (Jan. 4, 1996) (scope of publishing activities of an otherwise exempt school held to exceed the size and extent necessary to educate the organization's students and thus does not contribute importantly to the organization's exempt purposes).

Similarly, in *Iowa State University of Science & Technology v. United States*,[9] the Court evaluated whether the operation of a commercial television station by a state university was a related trade or business. The Court observed: "the method for determining and weighing the purposes of the activity in question is a comparison of the nature and size of the commercial television operations with the extent and scope of [the university's] educational operations."[10] The Court then focused on the degree to which the radio station was integrated into the educational program of the university and concluded that the radio station was unrelated.

Who are the recipients of the services – other nonprofits and/or others? The IRS will not recognize as exempt management and consulting services that are provided to non-exempt entities.

Charity currently provides consulting services to nonprofit organizations at a fee that is well-below cost. Charity's current activity fits within the line of cases, including *BSW* that permit Charity to engage in this activity as part of its tax-exempt operations. An attorney would be well-served to delve further into the issue with Charity and discuss what Charity considers to be its "cost" to make sure that there is a rational basis for this calculation.

Providing consulting services to nonprofit organizations at a fee that is above cost, but below market value is not going to qualify as an exempt activity. As is the case with the professionally staffed restaurant, this activity will generate unrelated business income, and depending on its size and scope, might jeopardize the tax exempt status of Charity.

[9] *Iowa State Univ. of Science & Tech. v. United States*, 500 F2d 508 (Ct. Cl. 1974). *See* also Tech. Adv. Mem. 9636001 (Jan. 4, 1996) (manner of carrying on publishing activities held to be consistent with a profit motive and to otherwise have characteristics of a trade or business within the meaning of Section 513).

[10] *Iowa State Univ. of* Science *& Tech. v. United States*, 500 F2d 508, 517 (Ct. Cl. 1974).

## III. UNRELATED BUSINESS TAXABLE INCOME

If some of Charity's activities are not in furtherance of an exempt purpose, then we have two related questions to address: (1) do the activities generate taxable income (this Section III), and (2) do the activities jeopardize the exempt status of the entity (Section IV). Remember Section 501(c)(3) tells us that an organization must be operated exclusively for exempt purposes, but the Regulations clarify that "exclusively" really means "primarily" generating and that exempt organizations are permitted to engage in some level of other activity.

Let us begin with a basic overview of how the unrelated business income tax ("UBIT") works.

Organizations that are tax-exempt under Section 501(c)(3) of the Code generally do not pay taxes on the income that they generate. There are two significant exceptions: private foundations pay a 2%, or sometimes a 1%, tax on their investment income,[11] and any Section 501(c) organization with UBTI pays UBIT on that income at the regular corporate tax rates.[12]

### A. Three Requirements

A Section 501(c) organization generates UBIT when it recognizes net income from:

- A trade or business, which is
- Regularly carried on, and which is
- Not substantially related to the organization's exempt purpose.

If any one of these elements is absent, we need look no further – there is no UBIT.[13]

**1. Trade or business.** A trade or business includes "any activity carried on for the production of income from the sale of goods or the performance of services."[14] The Regulations suggest that the term "trade or business" has the same meaning as it has under Section 162 in connection with analyzing the deductibility of business expenses.[15] Although there have been cases that analyze the "trade or business" element of the test, and although it is possible to have an income-generating activity that is not a "trade or business," as a practical

[11] Code Sec. 4940.

[12] Code Sec. 511.

[13] This paper presents a quick review of some of the key cases and rulings defining each of the three elements of the test. For a more thorough discussion of this topic, see CEB *Advising California Non-Profit Corporations*, Chapter 15 – "Taxation of Investment and Business Activities of Tax-Exempt Corporations," J. Patrick Whaley.

[14] Code Sec. 513(c); Reg. 1.513-1(b).

[15] Code Sec. 1.513-1(b).

matter, most potential UBIT matters that come to the attention of a practitioner are going to satisfy the "trade or business" element of the test.

**2. Regularly carried on.** The Regulations provide that whether or not a trade or business is regularly carried on is determined by examining the "frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued." The stated purpose in the Regulations is "to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete."[16]

The analysis of whether a particular activity is regularly carried on depends, of course, on all of the facts and circumstances, but the following guidelines can be drawn from the cases, rulings, and regulations, although the rulings and cases are by no means always consistent:

- It is important to compare the frequency and continuity of the activity with comparable activities being carried on by commercial entities. (Reg. 1.513-1(c)(1).) For example, if an activity is inherently seasonal, such as horseracing, then the regularity must be determined by examining the normal time span of comparable commercial activity. (Reg. 1.513-1(c)(2)(i).)

- An activity carried on one or two weeks a year is not likely to be regularly carried on, especially if other taxable entities engage in the same activity on a more regular basis. (Reg. 1.513-(c)(2)(i).)

- An activity carried on once a week, such as the operation of a commercial parking lot, each week of the year, is regularly carried on. (Reg. 1.513-1(c)(2)(i).)

- Annual or semi-annual fundraisers are typically not regularly carried on, even though they occur every year.

- In *NCAA v. Commissioner* 914 F.2d 1417 (10th Cir. 1990), the Court held that advertising in the NCAA program was not a regular activity, because the tournament had a very limited two- to three-week duration, even though the NCAA spent much of the year selling the advertising space. The IRS does not follow this case, and it is probably not prudent to rely on this case, especially outside of the 10th Circuit.

- In *Suffolk County Patrolmen's Benevolent Association* 77 T.C. 1314 (1981), the Court found that the production of an annual vaudeville show conducted over eight to sixteen weeks, including a printed program for the show that accepted advertisements, was not regularly carried on, even though the activities were conducted by professional fundraisers over a six-month period. The IRS acquiesced in this decision (AOD 1249, March 22, 1984), but it is not clear that the IRS would reach a similar conclusion today.

[16] Reg. Sec. 1.513-1(c).

**3. Substantially related.** Finally, if an exempt activity is substantially related to the organization's exempt purpose, it does not generate UBIT. The Regulations indicate that an activity is related to exempt purposes "only where the conduct of the business activity has a causal relationship to the achievement of exempt purposes," and the causal relationship must be substantial. (Reg. 1.513-1(d)(2).)

In analyzing whether a particular activity is substantially related to an organization's exempt purpose, the organization must first examine the exempt purpose set forth in its own organizing documents and its own charitable purpose. An activity that may be related to Organization X's exempt purpose may not be related to Organization Y's. With careful planning, however, it may be possible for Organization Y to engage in this activity by amending its Articles of Incorporation to expand its purposes and by providing proper notice to the IRS of the amendment.

There are far too many cases and rulings addressing the "substantially related" test to summarize in this short outline, but some interesting ones include:

- In *United States vs. American College of Physicians*, 475 U.S. 834 (1986), the Supreme Court examined the sale of advertisements in a medical journal. The Court held that the manner of selection and presentation of the ads was not substantially related to the organization's exempt purpose. The organization had argued that the purpose of the ads was to educate the readers, for example, about the products of pharmaceutical companies.

- The examples set forth in the recently issued final regulations on travel tours provide insight into when the IRS considers travel tours to be substantially related to an organization's exempt purpose.

- The museum gift shop rulings go to the heart of the substantially related test. They also illustrate the "fragmentation rule"; namely, that the IRS can look at a series of items sold in a gift shop (for example) and determine that some items, such as posters or cards depicting paintings, are substantially related and do not generate UBIT while other items, such as souvenirs of the city in which the museum is located, are not substantially related and do generate UBIT.[17]

- In PLR 200021056, the IRS ruled that the operation of a gift shop and tea room by an organization established to aid deserving women to earn their own living through their handiwork was not substantially related to the particular organization's exempt purpose.

- In PLR 200032050 the IRS considered a question that exempt organizations pose from time to time: Can an organization rent real estate (debt financed) to other

[17] *See*, e.g., Tech. Adv. Mem. 9550003 (1995) examining an array of related and unrelated items in a museum gift shop; see also Rev. Rul. 73-105, 1973-1 C.B. 264, which holds that the sale of scientific books and city souvenirs by a folk art museum is not related business.

nonprofit organizations without being subject to UBIT? The ruling indicates that one must examine whether the rental arrangement and the activities of the lessee further the exempt purpose of the organization. An organization whose mission is economic development – to improve the quality of life of individuals and families in the inner city – can rent to organizations such as childcare providers and social service agencies that help it carry out those purposes. The logic of the ruling also suggests, however, that if this organization were to rent to a qualified (c)(3) organization whose mission was, for example, preserving the environment or religious study, the rental arrangement would not be substantially related.[18]

There are, of course, many other rulings and cases in this area. Some areas, such as the relatedness of associate member dues or insurance programs provided to members, have led to the development of significant bodies of law, while many issues that arise are supported by minimal precedential guidance.

### B. Common Exceptions or Modifications to UBIT

Even if each of the three elements above is present, there are a variety of exceptions and modifications that can transform a UBIT activity into a non-taxable transaction. These exceptions and modifications include (but are not limited to):

- Interest income, dividends, and annuities. (Code Sec. 512(b)(1).)

- Royalties. (Code Sec. 512(b)(2).) Much of the discussion in connection with affinity credit cards has involved the definition of a royalty. These arrangements are described below.

- Rents derived primarily from real estate and a limited amount of personal property leased with the real estate. (Code Sec. 512(b)(3).) This exception does not apply if: (1) a lease involves more personal property than real estate; (2) the rental income is based at all on the net income or profits of the tenant; or (3) the lease involves the provision of significant services, other than those that are customary in a landlord-tenant relationship.

- Income from the sale of capital assets. (Code Sec. 512(b)(5).)

- Activities conducted for the convenience of members, students, patients, or employees. (Code Sec. 513(a)(2).) This exception typically applies to venues such as certain college bookstores or museum or school cafeterias.

- Activities conducted entirely by volunteers. (Code Sec. 513(a)(1).) This is an important exception because an activity that might otherwise clearly generate UBIT can be "cleansed" if it is conducted as an all-volunteer operation.

[18] *See* also Rev. Rul. 69-572, 1969-2 C.B. 119.

- Income from the sale of donated merchandise. (Code Sec. 513(a)(3).)

- Certain bingo games. (Code Sec. 513(f).)

- Corporate sponsorship payments. (Code Sec. 513(i).) Discussed below.

- Income from certain trade shows and state fairs. (Code Sec. 513(d).)

- Income from the rental of mailing lists to nonprofit organizations. (Code Sec. 513(h).)

### C. Exceptions to the Exceptions

An activity that satisfies each of the three UBIT tests, but appears not to be subject to UBIT because it qualifies under one of the exceptions, may nonetheless be subject to UBIT if one of the following exceptions to the exceptions applies:

- Interest, rent, and royalties received from a controlled corporation. (Code Sec. 512(b)(13).) While an exempt organization can normally receive interest, rents, and royalties from another entity without UBIT, the current law provides that these items, when received from an entity that the exempt organization "controls," are taxable. This section, which was amended during the last few years to redefine control, has been the subject of controversy. Many practitioners feel that the law puts exempt organizations on an uneven footing with taxable entities, and that only rents, royalties, and interest that exceed fair market value should be subject to UBIT. This rule may ultimately be changed.[19]

- A portion of the income derived from property acquired with debt financing can result in UBIT. These rules are set forth in Code Sec. 514. This issue most typically arises in the case of real estate acquired with debt, which is subsequently rented or sold for a purpose that is not substantially related to the organization's exempt purpose. It can also arise, however, in the case of securities acquired with debt, for example, on margin or in other situations.

### D. Other UBIT Issues

There are a series of other UBIT issues that arise and are not addressed in this outline. For example, special rules apply to income distributed from a partnership or S-corporation.[20]

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[19] *See* "TRA '97 Brings Charities a Little Relief . . . and Maybe a Lot of Grief," Robert A. Wexler and Lisa R. Appleberry, *Journal of Taxation* (December 1997), pp. 360-364.

[20] *See* Code Secs. 512(c) and 512(e).

## E. Mailing Lists and Affinity Credit Cards

During the 1990's, the IRS has challenged several mailing list and affinity credit card arrangements, arguing, on a number of different theories, that the income from these arrangements did not qualify as royalty income, which is an exception to UBIT under Section 512(b)(3). Typically, the IRS has argued that the organization that had rented its mailing lists or licensed its name and logo to a credit card company had also provided significant advertising, list compilation, and/or other services, so that the payments received were more in the form of compensation income rather than royalties. For the most part, the IRS has consistently lost these cases. The leading cases, which now provide the relevant authority, in this area are the following:

### 1. Mailing lists

*Disabled American Veterans v. U.S.*

- In 1981, the Court of Claims found for the IRS in one of the early mailing list cases. In this case, the Service argued that an organization's income from the rental or sale of mailing lists was not (passive) royalty income, because the organization provided significant services in connection with the mailing list. (650 F.2d 1178 (Ct. Cl. 1981).)

- In 1990, the Disabled American Veterans organization prevailed, this time in Tax Court, on largely the same facts for a later tax year. (94 TC 60 (1990).) The case was reversed on the basis of collateral estoppel. (942 F.2d 309 (6th Cir. 1991).) But the Ninth Circuit indicated that had it reached the merits, it would have found that the compensation was for services rather than a royalty.

- Section 513(h) of the Code was enacted specifically to permit the rental of mailing lists to certain exempt organizations.

*Sierra Club v. Commissioner.*

- In 1996, the Ninth Circuit Court of Appeals affirmed the Tax Court and determined that the Club's income from the rental of mailing lists was royalty income. 986 F.3d 1526 (9th Cir. 1996), affirming 103 T.C. No. 17 (1994).) The Court found that the Club had not provided too much in the way of services, and therefore, it received royalties and not compensation for services. The case left open the possibility that a particular organization could provide too much in the way of services, such as advertising, and change the character of the income.[21]

[21] *See*, e.g., *Texas Farm Bureau*, 53 F.3d 120 (5th Cir 1995), in a different setting, where too many services generated compensation income.

*Common Cause v. Commissioner*.

- Another favorable mailing list case for the taxpayer. (112 T.C. 332 (1999).)

*Planned Parenthood v. Commissioner*.

- Another favorable mailing list case for the taxpayer. (T.C. Memo 1999-206 (1999).)

As a result of these cases, the IRS will no longer pursue its position on mailing list cases under facts comparable to the cases described above.[22]

**2. Affinity credit cards**

*Sierra Club v. Commissioner*.

- The *Sierra Club* case, discussed above, also dealt with the affinity credit card issue. While the Ninth Circuit found for the Club on the mailing list issue, it remanded the affinity credit card portion of the case to the Tax Court for a finding as to whether the Club had provided too much in the way of services.

- The Tax Court on remand found for the Club, and the case was not appealed by the IRS. (T.C. Memo 1999-86.)

*Oregon State University Alumni Association Inc. v. Commissioner* and *Alumni Association of the University of Oregon v. Commissioner.*

- The Tax Court Memorandum opinions are at T.C. Memo 1996-63 (University of Oregon) and T.C. Memo 1996-34 (Oregon State).

- The Court of Appeals for the Ninth Circuit consolidated these cases and found for the schools. (193 F.3d 1098 (9th Cir. 1999).) In this case, the alumni associations had performed minimal services – less than 50 hours over two years. The Court immediately rejected the IRS' all-or-nothing approach – that any services tainted the entire arrangement. Judge Kleinfeld stated: "[v]iewed purposively, the royalty exclusion cannot be an all-or-nothing proposition." The Court further noted: "[t]he Commissioner has not suggested, and could not with a straight face, that commercial mailing list and promotion services would have been paid over a million dollars by the bank for around 50 hours of mostly secretarial and clerical work that the two alumni associations did during the two years at issue pursuant to the contracts with the bank." The Court

[22] *See* 28 *Exempt Organization Tax Review*, pp. 18-19 (Apr. 2000), discussing a December 1999 memorandum from the IRS indicating its new position on the matter.

> noted that if the bank were paying for services, given the amount of payment and the level of services, it would be paying $22,000 an hour for services. Therefore, the bank must have been paying for the use of the name.

The IRS has now indicated that, having lost several key court battles, it is no longer likely to challenge affinity credit card arrangements.[23] The IRS should now focus its efforts on evaluating precisely what types of services would cause a mailing list or affinity credit card arrangement to be partially taxable, how a payment might be allocated between taxable services and a passive license, and when too many services will cause an entire payment to be taxable UBIT.

## F. Corporate Sponsorship

### 1. History

Sponsorship in some form or another have long been a part of charitable activity. A wealthy corporation would donate money to a university, which in turn, would name a building after it. The law is well settled that this type of arrangement presents no significant legal issues. In the late 1980's, however, corporations and charities become more aggressive about sponsorship arrangements.

In 1991, the IRS issued a technical advice memorandum ("TAM"), TAM 9147007, which is commonly referred to as the "Cotton Bowl ruling." The Service determined that Mobil Oil Company's payment of more than one million dollars to the exempt organization that produced the Cotton Bowl constituted UBIT. The IRS reached a similar conclusion several months later in TAM 9231001 with respect to another football bowl game. The IRS determined that the sponsor's "contribution" was a payment in return for goods and services provided by the exempt organization as part of a trade or business, and therefore UBIT.

Practitioners and the exempt organization community objected strongly to the rulings. The IRS issued proposed audit guidelines which seemed to fortify the its position in the TAMs.[24] Perhaps concerned in part that public opinion would cause Congress to pass legislation in opposition to its position, the IRS issued a set of favorable Proposed Regulations under Section 513 in early 1993 to draw a distinction between advertising and mere donor acknowledgments.[25] These regulations permit the type of activity that was found to be taxable in the earlier TAMs.

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[23] *See* comments in 28 *Exempt Organization Tax Review*, pp. 18-19 (April 2000).

[24] Ann. 92-15, 1992-5 IRB 51.

[25] EE-74-92, Jan. 22, 1993.

### 2. The Code

In 1997 Congress added Section 513(i) to the Code to define nontaxable "qualified sponsorship payments." This Code section largely incorporated the thinking of the 1993 Proposed Regulations.

Under Section 513(i), an exempt organization's solicitation and receipt of a qualified sponsorship payment ("QSP") is not an unrelated trade or business. A QSP is any payment made by a person engaged in a trade or business where there is no arrangement or expectation that the person will receive any substantial return benefit for the payment. The recipient organization's use or acknowledgment of the payor's name, logo, or product lines is not a substantial return benefit.

Distinguished from an acknowledgment is advertising, which includes identifying the "sponsor's" products or services, such as through messages that contain qualitative or comparative language, price information, or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use the products or services.

In addition, any payment that is contingent on factors indicating the degree of public exposure to an event or events, such as the level of attendance at an event, or broadcast ratings, is not a QSP under Section 513(i)(2)(B)(i).

Section 513(i)(2)(B)(ii)(I) excludes from the definition of a QSP any payment that entitles the payor to acknowledgment of the payor's trade or business in "regularly scheduled and printed material" published by the recipient, other than material that is related to and distributed in connection with a specific event (such as a program). Therefore, the IRS continues to apply the rule of the *American College of Physician*s case and related rulings to periodical income.

Finally, payments received in connection with a qualified convention or trade show activity do not constitute QSPs under Section 513(i)(2)(B)(ii)(II). Such activities are otherwise excluded from the definition of an unrelated trade or business and are subject to special rules.

### 3. Regulations

On April 25, 2002, the Treasury Department released a set of final corporate sponsorship regulations. A detailed discussion of these regulations is beyond the scope of this paper, but they do help clarify some of the nuances left open by Section 513(i).

## G. Internet Issues

For several years now, the IRS and tax practitioners have been struggling with how to treat income-generating activities that involve the Internet. As an example, in an Announcement in the fall of 2000 (Announcement 2000-84; 2000-42 IRB 385), the IRS sought advice on several topics, including: (a) whether or not the IRS should issue guidance, (b) four general questions that affect more than one legal issue, (c) seven questions on lobbying and political activity, (d) three UBIT specific questions, and (e) three question dealing with substantiation and donor disclosure.

The IRS has indicated its intent to issue more formal guidance on Internet issues in the near future; but in the meantime, we continue to look for help in thinking about Internet issues. Consider two of the questions posed by the IRS in its 2000 Announcement:

1. To what extent are business activities conducted on the Internet regularly carried on under Section 512? What facts and circumstances are relevant in determining whether these activities on the Internet are regularly carried on?

    - One of the fundamental requirements for UBIT is that the activity is regularly carried on.[26] The analysis of whether a particular activity is regularly carried on depends, of course, on all of the facts and circumstances, and some of the guidelines are set forth on page 10 of this paper.

A website presents an exempt organization with the unique opportunity to "regularly carry on" an activity without exerting a great deal of additional effort, after the initial development of the site. Once something is posted on a website, it remains there until removed. On this question, we see no reason why the IRS should apply different rules in the context of the Internet. The basic rule from the Regulations, that we compare the frequency and continuity of the activity with comparable activities being carried on by commercial entities, should be the standard.

The IRS should take the position that the mere presence of a potentially unrelated business activity on a website for an extended period of time does not amount to regularly carrying on the activity. Rather, the IRS should look to the effort expended by the exempt organization in maintaining the site, as compared to comparable efforts put into live activities or commercial websites. In practice, most income-generating activities that continue for a period of time on a website will require regular updating and maintenance and will be regularly carried on. There are probably not many real-life examples in which an exempt organization puts an income-generating activity on a website and then does not have to work to maintain it on a regular basis.

For example, a charity might operate a virtual storefront, on which it sells items to the public, much like a gift shop that a museum would operate. If the storefront remains on-line on an ongoing basis, it will almost always be regularly carried on. The UBIT question in these situations will likely turn instead on a different test – whether the items sold are substantially related to the exempt organization's exempt purpose. The IRS should apply the same analysis that it currently applies in the context of museum and other gift shops, including application of the fragmentation rule, to determine whether particular items sold in a virtual storefront generate UBIT.[27]

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[26] Reg. 1.513-1(c).

[27] *See* TAM 9550003 and TAM 9720002 discussing the UBTI characterization of items sold at a museum gift shop; see also a discussion of this matter in the 1997 and 1999 CPE texts.

As another example, charities traditionally hold annual auctions to raise funds. Some of these charities are now conducting those auctions on-line and on a continual basis. An on-line auction should be considered regularly carried on if, when comparing the frequency and continuity of the activity, it is comparable to activities being carried on by commercial entities. (Reg. 1.513-1(c)(1).) If a charity really holds an auction for a limited number of days, it might not be regularly carried on. If a charity operates an ongoing auction, year-round or for some extended period of time each year, it probably would be regularly carried on.

Because the same rules that apply in the non-Internet context could apply to websites, the IRS does not necessarily need to offer specific guidance in this area.

2. Are there any circumstances under which the payment of a percentage of sales from customers referred by the exempt organization to another website would be substantially related under Section 513?

In order for income to be taxable, the income must be from an activity that is trade or business, that is regularly carried on (discussed above), and that is not substantially related to the organization's exempt purpose.[28] Even if all three tests are satisfied, exceptions and modifications under Sections 512 and 513, such as the royalty exception or the corporate sponsorship safe harbor, can apply to except the income from UBIT.

The Announcement poses a single narrow question. The answer to the narrow question is "yes." If an exempt organization refers customers to another website and receives a payment from the owner of the other website based on a percentage of sales from the referred customer, the payment should be substantially related if the product purchased by the customer is substantially related to the referring organization's exempt purpose. If environmental charity X sends its users to Amazon.com to buy a book on clear-cutting practices, and receives a percentage of the sales price, the income should be substantially related to X's exempt purposes, even though the income to X is based on a percentage of gross sales.

Many exempt organization websites feature books related to their mission and inform the user that the books may either be purchased in the organization's bookstore (if it has one) or on-line through an e-retailer such as Amazon.com. If an exempt organization could sell a book directly, in its own bookstore, it should be able to sell the same book through an Amazon.com; if the book is substantially related, it is always substantially related.

Some of the other interesting issues that come up from time to time are the following:

**Links and moving banners.** The most significant ongoing question seems to be: "When does a link that is included within an on-line acknowledgment, which otherwise appears to be corporate sponsorship, take the acknowledgment out of the corporate sponsorship safe harbor because it constitutes a substantial return benefit or more than an acknowledgment?" Links may be located in the logo of the corporate sponsor, in a banner atop the webpage, or in the text itself.

[28] Reg. 1.513-1.

The presence of a link to a corporate sponsor on a nonprofit's website has been analogized to listing a telephone number,[29] which is permitted under the corporate sponsorship rules. One private letter ruling has also indicated that a link may convert a sponsor's message into an advertisement.[30] However, the IRS in its Year 2000 CPE Text also stated that a link which is related to the exempt organization's purposes or activities may not be advertising, and one IRS official has indicated that unless a link generates income, it would probably not be deemed to constitute advertising.[31] Finally, yet another IRS official has since stated a refined perspective, indicating that the agency may differentiate between a link which takes the user directly to the main page of the sponsor and a link that takes the user to the sponsor's e-commerce page, which services transactions.[32]

The Regulations provide two helpful examples. The first example describes a symphony orchestra that acknowledges a sponsor on its website.[33] The sponsor's Internet address appears on the symphony's website in the form of a hyperlink to the sponsor's website. The symphony's website does not promote the sponsor or advertise its merchandise. The regulation states that the sponsor's entire payment is a QSP. This means that the hyperlink must not constitute a substantial return benefit. The example does not specify whether there is advertising content at the sponsor's linked site which, if attributed to the symphony, would constitute a substantial return benefit. Presumably most sponsor sites would include such content, and the mere fact of a link from the exempt organization's website will not result in attribution of the content at the linked site to the exempt organization for purposes of the QSP analysis.

The second example involves a health-based charity that receives funding from a pharmaceutical company to produce educational materials.[34] The sponsor's Internet address again appears on the charity's website in the form of a hyperlink to the sponsor's website. This time, however, a statement appears on the sponsor's website that the charity endorses the use of the sponsor's drug for a particular condition. The charity reviewed the endorsement and gave permission for it to appear. The regulation states that the endorsement is advertising and constitutes a substantial return benefit.

Many practitioners, including the author, believe that a link embedded in what otherwise constitutes a valid acknowledgment of a corporate sponsor should not alter the character of the sponsorship. A printed sponsorship acknowledgment may legitimately contain a phone number of the sponsor, which requires the reader to dial the telephone and contact the sponsor. A link,

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[29] *See* "D.C. Bar Internet Discussion Featured IRS's Bob Harper," 5 EO Tax J. 36 (December 1999/ January 2000) ("EO Tax J.").

[30] PLR 9723046.

[31] Exec. Assistant Jay Roots, 4 EO Tax J. 26 (July/August 1999).

[32] EO Tax J, *supra* n. 6, at 31. Mr. Harper also cleared up a long-standing question regarding an earlier IRS statement that "moving" banners would likely be considered advertising, noting that "Most moving banners are hot links."

[33] *See* Treas. Reg. § 1.513-4(f), Example 11.

[34] *See* Treas. Reg. § 1.513-4(f), Example 12.

although easier to access, is conceptually just like a phone number. The user must take the affirmative step of contacting the sponsor.

The preferred approach would be for the IRS to treat links just like the listing of a phone number in a corporate sponsorship. The presence or absence of a link should not affect the determination of whether the content of the statements on the exempt organization's website constitute advertising, rather than sponsorship.

**Virtual storefronts.** As indicated by the 2000 CPE Text, the approach of the IRS to traditional sales activity of nonprofits, such as museum gift shops, will also apply to the sale of merchandise from a website address that presents itself as an Internet store, or "virtual storefront." Generally, the IRS will look to the primary purpose of such sales, reviewing the nature, scope, and motivation for the sales activities in question. Under the fragmentation rule of Section 513(c), each item of merchandise would be evaluated separately as to whether its sale merely generates revenue or furthers the organization's exempt purposes.[35]

**On-line auction activities.** Typically, charities that conduct annual fundraising auctions do not pay UBIT on the amounts that donors pay for items. This is in part because the auctions are not "regularly carried on" – one of the requirements for UBIT – and also because in many cases, the goods that are being auctioned are all donated, one of the exceptions to UBIT.

Charities that conduct their own on-line auctions may avoid the imposition of UBIT if they are able to follow the usual charity auction fact patterns wherein the auction activities are not regularly carried on or the merchandise is donated, or both, as is commonly the case. However, in the Internet context, auctions are more likely to involve purchased goods, in addition to donated goods, and on-line auctions are more likely to be carried on regularly, or even continuously, rather than just once a year at the annual fundraiser. If charities want to avoid UBIT from on-line auctions, they need to take special care to structure the auctions correctly.

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The consulting business and the restaurant are both: (1) trades or businesses, (2) which will be regularly carried on, and (3) which are not substantially related to Charity's exempt purpose. None of the exceptions applies. One of the ways that we know that these activities are not substantially related to Charity's exempt activities is that these activities would not, on their own, qualify for tax-exemption (see Section II above).

[35] 2000 CPE Text, *supra* n. 12, at 138.

## IV. WHEN DOES TOO MUCH NON-EXEMPT ACTIVITY JEOPARDIZE TAX-EXEMPT STATUS?

We know that organizations must have a core activity that is exempt in nature. (See Section II.) If an organization operates a legitimate exempt activity, then it may also operate even a substantial unrelated trade or business without losing its exempt status as long as its primary purpose and activity is exempt. (Reg. 1.501(c)(3)-1(e).)

If an organization operates a core exempt activity, how do we know in how much unrelated activity it may engage? Organizations are sometimes concerned that if they generate too much money from an unrelated business activity, they will lose their exemption under Section 501(c)(3). Organizations sometimes report that they heard from their CPA that if their unrelated business income exceeds a certain percentage, such as 25% or 33%, they will automatically lose their exemption. The good news is that there is no automatic percentage rule.

Revenue Ruling 64-182, 1964-1 (part 2) C.B. 186, sets forth the "commensurate in scope" test, which is still followed today. This ruling stands for the principle that an organization may receive a significant amount of unrelated business income (whether taxable or nontaxable under an exception) as long as it carries out charitable programs that are commensurate in scope with its financial resources. In that ruling, the organization presumably received 100% of its income from the rental of real estate, but it engaged in grant-making activities that were commensurate in scope with its financial resources.

Other rulings expand on this concept to suggest that we do not look entirely at the percentage of income from an unrelated activity, but rather the full scope of operations of the charity. How much time is the charity spending on its exempt activities in relation to the time it is spending on generating income from investments and non-exempt activities? [36]

A leading treatise on the taxation of exempt organizations articulates the test very well:

> ....If the tax-exempt organization carries on one or more activities that further exempt purposes, such as operating a museum, hospital, school...and also conducts a clearly commercial activity, such as operating a restaurant, a determination must be made as to whether the effort expended to carry out exempt purposes is commensurate in scope with the organization's financial resources. This requires an evaluation of the time and effort undertaken by the organization in the conduct of the exempt activity or program, the impact of the exempt activity or programs, how the organization holds itself out to the public, and the use of net after-tax UBI. [footnotes omitted].[37]

As a practical matter, if it is a close call as to whether an unrelated activity is beginning to overshadow the exempt purposes and activities of the organization, we would recommend

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[36] *See* PLR 200021056 (this ruling reached the correct result through some unusual reasoning); see also TAM 9711003 (charity retained exemption where 95 percent of its income was UBIT); see also PLR 8038004.

[37] *Taxation of Exempt Organizations*, Hill and Mancino, Warren, Gorham & Lamont of RIA, pages 21-17 through 21-18, updated regularly.

dropping the business activity into another organization, usually a for-profit corporation. The next Section explores some of the options and the consequences of those options.

Without more facts about the scope and extent of the operation of the new activities in comparison to the existing activities, it is not possible to determine whether the new activities will jeopardize Charity's tax-exempt status. In addition, this analysis may change over time as the "for-profit" activities become more successful. In all likelihood (either early on or later on), it will make sense to consider an alternative legal structure for these businesses.

## V. OPTIONS FOR STRUCTURING A CHARITY'S NEW UNRELATED BUSINESS ACTIVITIES

When a charity has both exempt and non-exempt activities, it needs to consider the advantages and disadvantages of keeping the activity within the charity or dropping the activity into another legal entity. The other legal entity might be a for-profit subsidiary of the charity (i.e., a corporation controlled by the charity), a stand-alone corporation that is not technically controlled by the charity but has some affiliation with the charity, or a limited liability company. In this outline, we refer for simplicity to the unrelated business activity in question as the "new activity." Let us consider the tax and other legal affects of these options:

**Option A: Keeping the unrelated activity within the existing charity.**

*Advantages:*

- If Charity has a net loss form one unrelated business activity, and the new activity in question will generate profits, Charity can use losses from one to offset some profit; reverse is also true, if Charity has UBTI and new activities will generate losses.

- New activities can freely use Charity's name and goodwill, as well as tangible assets and human resources, without the cumbersome complexity of entering into licensing, rental, or resource-sharing agreements.

- Minimal legal fees associated with troubleshooting and minimizing UBTI; only one corporation to maintain and for which to file returns.

- If and when new activities terminate, any appreciated assets used in those activities belong to Charity without a taxable transfer.

*Disadvantages:*

- If Charity already has substantial UBTI and new activities will be so substantial that exempt activities of Charity appear secondary to aggregate of unrelated activities, there is a risk to exempt status.

- New activities may appear inappropriate for Charity from a public relations standpoint. Any potential liabilities associated with new activities will clearly be liabilities of Charity and the responsibility of its Board of Directors.

**Option B: Forming a wholly owned or majority-owned for-profit subsidiary of the existing charity.**

*Advantages:*

- Eliminates risk to Charity's exempt status (if done properly).
- Eliminates any confusion in public eye concerning Charity and its activities.
- If properly structured and operated, provides insulation from liabilities arising from new activities which are now localized in the subsidiary.
- Dividends received from subsidiary are not taxable as UBTI (although dividends are also not deductible by the subsidiary).

*Disadvantages:*

- Since new activities are unrelated to Charity's exempt purposes, investment in the new corporation must satisfy a "prudent investment" standard. This must be a sensible use of Charity's resources.
- Start-up costs to form new corporation; ongoing costs of maintaining two separate corporations is higher.
- Any profit on services provided by Charity to the new corporation will generate taxable income, although pure expense reimbursement is permitted.
- On eventual dissolution, transfer of any appreciated assets to shareholders will constitute a deemed sale of the assets at the subsidiary level, which must pay taxes on that deemed sale.
- Charity must have the investment assets available to adequately capitalize the subsidiary.
- Appropriate tradename and trademark licensing, resource (including employee) sharing/allocation, office rental, mailing list rental, equipment rental, and other agreements will be needed between Charity and subsidiary, in which charity must receive at least fair market value under all circumstances.
- Additional UBIT issues arise if Charity must use debt financing to capitalize the new corporation.

*Share Ownership and Control Issues:*

- Charity must address who (other than Charity) will be allowed to own shares in the new corporation and what Charity's equity share will be, and find other investors.

- If Charity owns less than 100% of the stock, allows use of stock incentives for key employees.

- If Charity owns no more than 50% of the new corporation, then interest, annuities, royalties, or rent paid by the new corporation to Charity are shielded from UBIT; correspondingly, if Charity owns more than 50% of the new corporation, then interest, annuities, royalties, and rents received by Charity from the new corporation *are subject to UBIT*.

- If the new corporation is too closely controlled by Charity, the new corporation's activities may be attributed to Charity for tax and other purposes, with the same results as if no new corporation had been formed. For this reason, the subsidiary's Board should not be identical to that of Charity, and separate corporate identities should be scrupulously observed.

- Depending on number, residence, and sophistication of investors other than Charity, securities law compliance costs and delays may be substantial. If participation is limited to small number of key employees or Charity members who reside in California, securities compliance will be minimal.

**Option C: Forming a "stand alone" corporation.**

*Advantages:*

- No risk to Charity's tax-exempt status.

- No liability to Charity's Board for new corporation's activities, under any circumstances.

- Same UBIT advantages as a no-more-than-50%-controlled subsidiary.

- Charity does not have to provide any capitalization to the new corporation; no prudent investment standard applies because there is no investment.

- Expense and inconvenience of starting up and maintaining separate corporate entity from Charity do not fall directly or indirectly on Charity (although some of the same people or organizations may be involved in both).

*Disadvantages:*

- No Charity control (at least directly).

- No dividends to Charity (although Charity could benefit financially through other arrangements mentioned above, some of which would be subject to UBIT), and no share in assets on dissolution.

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It is worth noting that in any case in which a charity forms a for-profit subsidiary or a stand-alone corporation, the goal is to make sure the subsidiary will hold up in court as a valid separate legal entity and that the activities of the subsidiary will not be attributable to the charity. In order to accomplish this goal, the structure should follow some basic rules:

1. The subsidiary needs to have a reasonable amount of money (capital) to be able to meet its day-to-day needs and expenses.

2. The subsidiary needs to hold board meetings, at least annually, and keep minutes of those meetings. The subsidiary should keep a clean and clear set of corporate records to show that it is a legitimate legal entity. The subsidiary needs its own bank accounts, tax identification number, and records. It needs to be current on its tax and other filings.

3. The charity, as shareholder, can elect the Board, and legally the Board of the subsidiary could even be identical to the Board of the charity, but lawyers typically recommend keeping a majority of the Board of the subsidiary different from the Board of the charity. There are at least three reasons for this suggestion. First, the subsidiary is operating a business. There may be individuals with business experience who can really help the subsidiary's business who are not already on the nonprofit board. Second, it allows the disinterested Board members of the subsidiary to properly approve transactions involving the charity. Third, it demonstrates to the outside world, in case of challenge, that these are separate functioning entities not to be collapsed into one for liability purposes.

4. The charity and the subsidiary can share facilities and employees, but there should be a proper resource-sharing agreement whereby each entity pays its own share of expenses. Ideally, of course, the subsidiary would have its own premises and its own employees.

Another option is the limited liability company ("LLC"). Unlike a corporation, that pays tax at the corporate level, an LLC typically elects to pass its income and expenses through to its partners or members, and they pay tax on the income at the partner or member level.[38] The

[38] Actually, partnerships and LLC's can elect to be taxed either as partnerships or as corporations, but most elect partnership tax treatment.

shareholders of a corporation are normally not liable for the activities of the corporation in which they own shares. This, historically, has been a chief advantage of incorporating. The general partners of a partnership are typically fully liable for the activities of the partnership. The limited partners of a limited partnership are not liable, but they have only minimal voting rights. The LLC is, in a sense, a hybrid vehicle that provides no liability to its members, who can be fully involved in control and voting issues, but at the same time, allows for partnership, or pass-through, style tax treatment.

In all likelihood, the LLC is not a valuable vehicle for a charity that is trying to spin off a business that would otherwise generate UBTI. Why? Because the income of the LLC will be passed through to the charity, and the activities of the LLC will be attributed to the charity. Therefore, while there are many uses for an LLC, such as holding real estate or other high liability property for a charity, avoiding UBIT and isolating UBIT assets is not one of them.

Consider some of the specific advantages and disadvantages to using an LLC:

*Advantages:*

- Eliminates confusion in public eye concerning Charity and its activities.
- If properly structured and operated, provides insulation from liabilities arising from new activities which are now localized in the subsidiary.
- An LLC or partnership can liquidate with an entity level tax.
- Can allow for some investors that are not charities.

*Disadvantages:*

- Since new activities are unrelated to Charity's exempt purposes, investment in the new corporation must satisfy a "prudent investment" standard. This must be a sensible use of Charity's resources.
- Unlike with a corporate subsidiary, the IRS may attribute the activities of the LLC or partnership to Charity. Thus, it may not be a useful tool for moving a substantial business activity out of Charity.
- Start-up costs to form new organization; ongoing costs of maintaining two separate corporations are higher.
- All net income from the LLC or partnership will be passed through to Charity on a K-1 tax form, and Charity will pay UBIT on the income.
- Appropriate tradename and trademark licensing, resource (including employee) sharing/allocation, office rental, mailing list rental, equipment

rental, and other agreements will be needed between Charity and LLC, in which charity must receive at least fair market value under all circumstances.

We have discussed throughout this paper the tax consequences of the funds flowing between a charity and entities in which it has an interest. The information below looks at three major events: (1) capitalizing the new entity, (2) money coming back to the charity during the day-to-day operations of the entity, and (3) the liquidation of the entity.

In order to keep this information reasonably brief, we make the following assumptions:

- In the LLC model, we have Charity and at least one other LLC member, which could also be another charity. We assume that the LLC is electing partnership tax treatment, and therefore, this model applies also to partnerships.

- In the Subsidiary or "Sub" model, Charity owns at least 51% of the stock.

- In the independent corporation model, or "IC" model, Charity owns less than 51% of the stock.

- Charity does not use debt to finance its investment in the entity.

- The activity of the entity is a trade or business, that is regularly carried on, and that is not substantially related to Charity's exempt purposes.

## A. Capitalizing the Entity

The entity will need some combination of capital contributions and loans from Charity and other investors, if any. Normally, Charity can make a capital contribution or loan to a Sub, an IC, or an LLC with no immediate tax consequences. However, Charity must make sure that it receives fair value in return for its contribution or loan. Therefore, if there are other investors, Charity must receive stock or LLC interest with a fair market value equal to the amount it contributes. Because it is very difficult to value stock in a new entity, we would look mostly to the relative value of what Charity receives for its contribution versus what other investors receive for theirs. With respect to a loan, we would look for a market interest rate and other market terms.

## B. Income from Ordinary Operations

| Type of Entity | Profits | Dividends | Interest on Loans | Royalties for Intellectual Property | Rent for Real Estate |
|---|---|---|---|---|---|
| **SUB** | Tax at the Sub level only | Not taxed to Charity, but not deducted by Sub | UBIT to Charity, deductible by Sub | UBIT to Charity, deductible by Sub | UBIT to Charity, deductible by Sub |
| **IC** | Tax at the IC level only | Not taxed to Charity, but not deducted by IC | Not UBIT to Charity, deductible by IC | Not UBIT to Charity, deductible by IC | Not UBIT to Charity, deductible by IC |
| **LLC** | LLC provides Charity with a K-1, and Charity files a 990-T UBIT return to pay tax on its share of income | LLC's do not pay dividends | Taxable to Charity if Charity has a greater than 50% interest in LLC. Charity's share of the deduction by LLC passes through on K-1 to Charity | Taxable to Charity if Charity has a greater than 50% interest in LLC. Charity's share of the deduction by LLC passes through on K-1 to Charity | Taxable to Charity if Charity has a greater than 50% interest in LLC. Charity's share of the deduction by LLC passes through on K-1 to Charity |

## C. Liquidation of Entity

At some point the entity will likely terminate and liquidate or sell its assets.

| Entity | Liquidation | Sale |
|---|---|---|
| **SUB** | Deemed sale of assets, taxable at Sub level. No tax to Charity | Tax at Sub level, not at Charity level |
| **IC** | Deemed sale of assets taxable at IC level. No tax to Charity. | Tax at IC level, not at Charity level. |
| **LLC** | No LLC level tax; usually no tax to Charity | Gain on sale is passed through to Charity. Some of the income may be taxable and some not to Charity. |

## CONCLUSIONS

Whenever a charity is considering engaging in an income-generating activity, it should consider the following questions, which have been discussed throughout the paper. It should also continue to review these issues periodically since what may start out as a limited business endeavor may begin to require more and more attention over time.

1. Is the activity consistent with the charity's existing exempt purpose? Review the Articles of Incorporation, donor restrictions, and the mission statements. If possible and necessary, change the Articles to permit the contemplated activity.

2. Is the activity consistent with recognized IRS exempt purposes? See Section II, above.

3. If not, does the activity generate UBIT? See Section III above.

4. If the activity is not consistent with exempt purposes, then regardless of whether it generates UBIT, is the scope of the activity significant enough to jeopardize exempt status? See Section IV above.

5. If the activity is significant, could the activity reasonably be dropped into another organization? See Section V above.

6. What is the correct form of new organization?

7. How will the flow of funds be taxed?