

**REVENUE-GENERATING ACTIVITIES
OF
CHARITABLE ORGANIZATIONS:
LEGAL ISSUES**

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Presented by:

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AGENDA FOR SESSION

- I. Introduction.
- II. Revenue-generating activities that qualify for tax-exemption.
- III. Unrelated Business Taxable Income.
- IV. Exempt organizations and subsidiaries, partnerships, and LLCs.
- V. Special Topics:
 - A. Corporate Sponsorship
 - B. The Internet

SUPPLEMENTAL MATERIALS

INTRODUCTION

Before the mid-1990's, phrases and concepts such as social entrepreneurship, venture philanthropy, social return on investment, affinity credit card deals, corporate sponsorship opportunities, public/private partnering, and branding were rarely uttered by influential individuals in the nonprofit sector. Now these concepts, as well as other more entrepreneurial notions, are part and parcel of everyday philanthropic vocabulary in the United States. No longer are innovative, entrepreneurial ideas dismissed out of hand by the Board of Directors when considering ways to make charitable programs self-sustaining or ways to raise funds to support charitable programs.

Why the sea change? We believe that there are at least three trends that have emerged, and that continue to evolve, among the clients with which we have had the opportunity to work and among other organizations that we have observed:

1. Operating charities, hoping to rely less on private foundation grants and government funding, have been actively looking for ways to ensure their own survival through income-generating activities. Sometimes organizations look to become self-sufficient from the income generated from their own core nonprofit activities, a phenomenon that some refer to as social entrepreneurship.
2. Other organizations have sought to profit commercially from the goodwill that they have already created through their charitable good works; thus the now accepted practice of credit card companies and other corporations willing to pay for the use of the charity's good name in selling their own products or by sponsoring a charity event.
3. Endowed public charities or well-funded private foundations have become significantly more innovative in making equity investments in partnerships, limited liability companies, and corporations in order to further their charitable mission, but also with the prospect, however remote, of receiving a return on their investment. Sometimes, but not always the funder also wants an active, or at least supervisory role, in the project. This trend is, in some circles, referred to as venture philanthropy.

While some may view these three trends as distinctly separate, there is an important intersection between the legal issues involved. Each of these trends involves an analysis of whether the underlying activity is consistent with the tax exempt status of the exempt organization, and each of these activities involves a consideration of unrelated business income tax issues.

This paper is intended as a basic guide to assist charities that seek to engage in income-generating activities in focusing their thinking about legal issues, after they have already

developed their ideas about how to further their charitable mission by generating revenue.¹ While charities should by no means shape their vision based on the legal framework, they need to understand the basic legal principles in order to be able to know what will work and what will not work within the context of a charitable organization.

To address these issues, this article is divided into the following parts:

- I. A common definition of terms.
- II. When is an income-generating activity, conducted directly by a charity, consistent with that charity's exempt function and mission?
- III. If an activity conducted directly by a charity is not part of the charity's exempt function, when is it subject to the unrelated business income tax?
- IV. How much unrelated business income activity can a charity engage in?
- V. What are the advantages and disadvantages of dropping a business activity into a for-profit corporate subsidiary?
- VI. How does a charity establish a for-profit or nonprofit subsidiary?
- VII. How do the rules differ where a charity forms an LLC or partnership?
- VIII. How are funds flowing from a charity to a subsidiary, and visa versa, treated for tax purposes?

¹ Every nonprofit organization contemplating a revenue generating activity should consult with its own legal counsel, with its own certified public accountant and with any other advisors and consultants that it deems appropriate before proceeding.

I. DEFINITION OF TERMS

A. Nonprofit Organization

The term “nonprofit organization” generally refers to the legal (not tax) status of an organization. It could refer to a nonprofit corporation, association, or trust. The entity could, of course, be organized in any state, even if it is doing business in another state. For purposes of simplicity, we will focus this Article on nonprofit corporations.

B. Nonprofit Corporation

Nonprofit corporations come in different flavors. In California, for example, we have public benefit, mutual benefit, and religious nonprofit corporations. Mutual benefit corporations are typically (but not always) clubs, trade associations, or other organizations established for the “mutual benefit” of a membership group. Religious corporations include both churches, synagogues, mosques, and the like, and also any nonprofit corporation whose primary mission is religious. Public benefit corporations include most California nonprofit corporations that are established to engage in charitable, educational, health-related, or scientific work.

C. Tax-Exempt Organization

A nonprofit corporation is usually, but not always, tax-exempt. There are at least 27 different categories of tax exemption at the federal and state levels. In this Article, however, we assume that we are talking about a nonprofit public benefit corporation that is tax-exempt under Internal Revenue Code (“IRC” or “Code”) Section 501(c)(3) and its California counterpart, Revenue and Taxation Code Section 23701d.

D. “Foundation” Status

A tax-exempt 501(c)(3) organization can be either a private foundation or a non-private foundation (also known as a public charity), based either on its primary activity or its sources of support. Private foundations, as a general rule, are subject to more restrictions than public charities. Although both private foundations and public charities can engage in income-generating activities, the rules are more restrictive for private foundations, particularly where the income may be taxable as unrelated business income.

E. “Charity”

In this paper, therefore, we use the word “Charity” to refer to a California nonprofit public benefit corporation that is tax-exempt under Section 501(c)(3) and that is not a private foundation. All of the tax concepts discussed in this paper would apply equally to nonprofit corporations organized in other states.

II. INCOME-GENERATING ACTIVITIES THAT ARE CONSISTENT WITH EXEMPT STATUS

In order to understand when a Charity can engage in income-generating activities consistent with its exempt purpose, we need to discuss first the basics of tax-exemption. As a general rule, but not in every case, the state tax rules in California and in other states mirror the federal rules. In this Section, we will first look at general rules applicable to all Section 501(c)(3) organizations. We will then explore some specific types of activities that generate income. A full examination of all types of income-producing activities would, unfortunately, require a textbook-length discussion.

A. Rules Applicable to All 501(c)(3) Organizations

IRC Section 501(c)(3) defines tax-exempt organizations as follows:

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, no part of the net earnings of which inure to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Put more simply, in order to qualify as a tax-exempt charitable organization, an entity must be organized and operated for one or more of the exempt purposes listed above, and it must refrain from inurement, electioneering, and substantial lobbying.

1. Organizational test

The organization's governing document – whether articles of incorporation, articles of association, or a trust agreement – must meet certain requirements in order to satisfy the organizational test. The document must limit the charity's purposes to one or more of the purposes listed in IRC Section 501(c)(3). Moreover, it must not “expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.” (Reg. Sec. 1.501(c)(3)-1(b)(1)(i)(b).) In practice, the charity must also include an affirmation that it will not engage in prohibited political activities. Finally, it must make clear that its assets are irrevocably dedicated to one or more exempt purposes. For a recent discussion of the parameters of this test, see the IRS website (www.IRS.gov/charities), article titled “Organizational Test – IRC 501(c)(3)” by Elizabeth Ardoin.

2. Operational test

The operational test forms the heart of the discussion in this paper. IRC 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 activities may be devoted to non-exempt purposes. (Reg. Sec. 1.501(c)(3)-1(c)(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. (IRC Sections 511-515, generally; Reg. Sec. 1.501(c)(3)-1(e)(2).) And private interests may benefit from the charity’s activities if that benefit is an unavoidable incident of the charity’s otherwise proper activities. However, the operational test requires a charity to “establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.” (Reg. Sec. 1.501(c)(3)-1(d)(1)(ii).)

3. Prohibition of inurement

IRC Section 501(c)(3) specifically requires that “no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual” The IRS Chief Counsel’s office has written that “[i]nurement is likely to arise where the financial benefit represents a transfer of the organization’s financial resources to an individual solely by virtue of the individual’s relationship with the organization, and without regard to accomplishing exempt purposes.” (Gen. Couns. Mem. 38,459 (July 31, 1980).)

The IRS takes the position that “all persons performing services for an organization have a personal and private interest [in that organization] and therefore possess the requisite relationship necessary to find private benefit or inurement.” (Gen. Couns. Mem. 39,670 (June 17, 1987).) The Tax Court, however, does not cast its net quite this broadly. Rather than assume that all employees are insiders when testing for inurement, the Tax Court has stated that an insider is one who has a unique relationship with the organization by which the insider, by virtue of his or her control or influence over the organization, can cause its funds or property to be applied for the insider’s private purposes. (*American Campaign Academy v. U.S.*, 92 T.C. 1053 (1989).)

IRC Section 4958 provides the IRS with the ability to impose intermediate sanctions, short of revocation of exempt status, on insiders who engage in excess benefit transactions. As the law under Section 4958 evolves, it is likely that the definition of insiders or “disqualified persons” under Section 4958 will also be used to define insiders for purposes of the inurement prohibition. It is also likely that given the right to impose intermediate sanctions on insiders who profit from a Charity improperly, the IRS is less likely to pursue revocations on grounds of inurement.

4. Prohibition of electioneering

A charity may not support or oppose candidates for public office. The IRS considers this prohibition to be absolute. The Chief Counsel’s office has stated that “an organization described in IRC Section 501(c)(3) is precluded from engaging in any political campaign activities.” (Gen.

Couns. Mem. 39,694 (Jan. 22, 1988) (emphasis added).) Some activities that initially appear overtly political may not, however, constitute prohibited electioneering. Where students in a political science course were required to participate in political campaigns of their choosing as part of their course work, or where the college provided facilities and faculty advisors for a student newspaper that published student-written editorials on political matters, the IRS has ruled that the college was not itself breaking the rules against supporting or opposing candidates. (Rev. Rul. 72-512, 1972-2 C.B. 246; Rev. Rul. 72-513, 1972-2 C.B. 246.) A charity is also allowed to register voters, to urge registered voters to vote, and to educate voters, so long as its activities are nonpartisan. (IRC Section 4945(f); Reg. Sec. 53.4945-3(b); Rev. Rul. 78-248, 1978-1 C.B. 154.)

5. Prohibition of substantial lobbying

A charity may not devote a substantial part of its activities to attempting to influence legislation. However, charities that are neither churches nor private foundations may quite properly engage in legislative lobbying without risking their tax-exempt status, so long as lobbying remains an insubstantial part of their overall activities, by taking advantage of the provisions of IRC Sections 501(h) and 4911. The former defines substantiality with reference to a charity's expenditures on lobbying, and the latter defines precisely what is and is not lobbying.

Even under the "insubstantiality" test, much advocacy commonly conducted by charities does not rise to the level of lobbying. A charity can attempt to influence the actions of government officials aside from legislative decisions, advocate its views through public interest litigation, convene conferences on public policy issues even if those issues are controversial, and express its views on those issues through advertisements, all without engaging in lobbying as the IRS understands the term.

B. Some Examples of Exempt Income-Generating Activities

For purposes of this paper, we assume that the Charity is properly organized and therefore satisfies the organizational test and that the Articles of Incorporation contain a broadly written purposes clause that permits the particular income-generating activity being contemplated. If the Articles do not contain a broad purposes clause that would cover the activity being contemplated, they should be amended before engaging in the activity in question.²

We also assume that the Charity is not engaging in impermissible activities such as excess lobbying, candidate activity, private inurement, or private benefit transactions. That is not to say that private inurement and excess compensation issues do not arise in situations involving "activities, particularly where a related for-profit corporation or business is involved. Rather, we assume for purposes of this paper that the Charity will take appropriate steps to

² State law charitable trust rules, however, may limit the ability of a public benefit corporation to use assets that were received for one purpose, prior to an Articles amendment, for a new purpose.

ensure that any compensation paid to insiders or to related for-profit entities is reasonable in amount and is approved using procedures outlined in Internal Revenue Code Section 4958.³

We focus then on the *operational test*. Does the operation of the contemplated activity fall within the range of activities permitted under Section 501(c)(3). If it does, then the activity is permitted, and the Charity pays no tax on the income from the activity. If it does not, the Charity may still be able to engage in the activity and possibly pay the unrelated business income tax, or the activity may be so substantial that the Charity needs to relocate the activity into a separate legal entity, such as a subsidiary corporation.

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, in the end, 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*, D. D.C. No. 02-0785 (9/24/03).)

There is no single test for evaluating whether an income-generating activity is an appropriate exempt activity. Over time, the courts and the IRS have developed legal tests and frameworks for different types of activities that generate income. In the Author’s experience, the more an activity fits within the realm of activities that have traditionally been recognized as charitable, the more likely the activity is to generate exempt income. The less the activity looks and feels like a traditional charitable endeavor, the more scrutiny the IRS will apply. As an example, it is relatively easy for hospitals and schools, activities which have traditionally been exempt, to qualify for exemption as long as they do not improperly benefit insiders, do not discriminate, and provide an appropriate level of service to those who cannot afford to pay. On the other hand, the tests are more difficult to satisfy in areas such as publishing or fee-based management or consulting services.

In analyzing whether a particular activity is operated for exempt purposes, we must first identify the exempt purpose that the activity purports to further. The exempt purposes recognized by the IRS include:

- (a) Religious
- (b) Charitable
- (c) Scientific
- (d) Testing for public safety
- (e) Literary
- (f) Educational, or
- (g) Prevention of cruelty to children or animals

While one can potentially identify income-producing activities in connection with any valid exempt purpose, the purposes most likely to be relevant to income-generating activities are, in no particular order, scientific, educational, and general charitable.

³ IRC Section 4958 provides excise taxes for transactions which result in excess benefits being paid to certain insiders. Charities can follow certain disclosure and abstention procedures in order to qualify for a presumption of reasonableness.

1. Scientific

Charities have the ability to make money from developing marketable patents or actual goods that result from scientific research. The Regulations (1.501(c)(3)-1(d)(5)) provide that “since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a scientific organization must be organized and operated in the public interest. Therefore, the term scientific, as used in section 501(c)(3), includes the carrying on of scientific research in the public interest.”

As an example, University A is researching and developing a medical device. The University will make the results of its research public, and file a patent on the technology. Dr. X, the principal researcher, and the University will work with manufacturers to build and market the device, and the University and Dr. X will each receive a royalty payment for each unit that is sold. Is the development of the medical device and license of the patented technology an exempt activity?

The Regulations tell us that scientific research will be regarded as carried on in the public interest:

- (a) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis;
- (b) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or
- (c) If such research is directed toward benefiting the public.

The Regulations further provide some examples of research that is in the public interest and therefore exempt in nature:

- (1) Scientific research carried on for the purpose of aiding in the scientific education of college or university students;
- (2) Scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public;
- (3) Scientific research carried on for the purpose of discovering a cure for a disease; or
- (4) Scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.

Scientific research described above will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.

On the other hand, the Regulations tell us that an organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under Section 501(c)(3) as a scientific organization, if:

- (a) Such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or
- (b) Such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public.

The Regulations clarify that for purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public.

In the example above, then, University A could conduct research to develop medical technology as long as it is made available to the public. In addition, the University and Dr. X could participate in marketing and selling the technology. There are a series of more specific rulings and cases that one should consult before engaging in any scientific research projects.

2. Educational

The Regulations (1.501(c)(3)-1(d)(3)(i)) provide that the term “educational” relates to:

- a. The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- b. The instruction of the public on subjects useful to the individual and beneficial to the community.

The Regulations provide some examples:

Example 1. An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Schools must also demonstrate that they operate in a non-discriminatory manner.

Example 2. An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example 3. An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example 4. Museums, zoos, planetariums, symphony orchestras, and other similar organizations.

There are many examples of organizations that generate revenue through educational activities. Two areas of educational activities that can generate income and border the realm of for-profit activity are publishing and the operation of conference centers. These are but two examples, but let's explore what the law has said about these.

a. Publishing. Publishing can be exempt if it is carried out in a "noncommercial" manner, as described in a 1967 Revenue Ruling. (Revenue Ruling 67-4, 1967-1 C.B. 121.) This ruling and Revenue Ruling 66-147, 1966-1 C.B.137, hold that:

an organization engaged in publishing scientific and medical literature may qualify for exemption from Federal income tax under section 501(c) (3) of the Code if (1) the content of the publication is educational, (2) the preparation of material follows methods generally accepted as "educational" in character, (3) the distribution of the materials is necessary or valuable in achieving the organization's educational and scientific purposes, and (4) the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.

The Rulings further provide that the methods used in preparing and presenting the abstracts should conform to methods traditionally accepted as "educational" in character. Among other things, the charges for the publication should recover only a portion of the costs of producing the publication.

The 1966 and 1967 Revenue Rulings were applied in Rev. Rul. 79-369. That Ruling examines an organization that was created to stimulate, promote, encourage, and sustain interest in and appreciation of contemporary symphonic and chamber music. Some additional relevant facts were:

- The organization recorded the new works of unrecognized composers as well as the neglected works of more established composers.
- The music selected for recording had a limited commercial market and was not generally produced by the commercial music publishing and recording industry for sale to the public.

- The organization sold its recordings primarily to libraries and educational institutions. Some records were provided free to radio stations operated by educational institutions. The organization also made some sales to individuals.
- The records were not made available for sale through commercial record dealers except in a few specialty shops, but were sold through mail orders.
- The organization did not engage in any advertising, but relied upon those who were interested in this type of music to communicate the availability of the records.
- All sales were facilitated by the use of a catalog published by the organization.
- The catalog contents included information about the compositions and the composers.
- This information was retained in the catalog so that the catalog served as an archive with respect to these compositions and recordings.
- Copies of all recordings were maintained for availability in the future.
- The liner notes on the album covers contained a biography of the composer and a description of the composition by its composer.
- Compositions to be recorded by the organization were selected by an editorial board. The members of the editorial board were appointed by the president of the organization. The board was comprised of recognized experts in the contemporary music field, none of whose works might be considered for recording. Members of the board were replaced every two years to insure selection of a broad range of compositional styles. Selections were made based upon the quality of the work rather than any potential for profit.
- Composers received royalties from the sale of recordings as required by federal law. Due to the limited commercial market for this type of music, the royalties received by the composers were insignificant. Pursuant to contractual agreement, nonexempt corporations and individuals that provide subsidies for the production of recordings received 9% of the gross sales in repayment but could not be paid an amount greater than their subsidy.
- The organization's deficits were made up by means of contributions from the public and grants from organizations exempt from federal income tax under Section 501(c) (3) of the Code.

The IRS determined, based on these very favorable facts, that the “the recording and sale of musical compositions, not generally produced by the commercial recording industry, is similar to the publication and sale of educational material in a noncommercial manner. (Rev. Rul. 67-4, 1967-1 C.B. 121.)

In Rev. Rul. 77-4, 1977-1 C.B. 141, the IRS reviewed the publication of an ethnic newspaper. It found that a nonprofit organization, whose only activities were preparing and publishing a newspaper of local, national, and international news articles with an ethnic emphasis, soliciting advertising and selling subscriptions to that newspaper in a manner indistinguishable from ordinary commercial publishing practices, was not operated exclusively for charitable and educational purposes and did not qualify for exemption.

In the seminal case of *Presbyterian and Reformed Publishing Co., Appellant v. Commissioner of Internal Revenue*, 743 F.2d 148 (3rd Cir. 1984), the U.S. Court of Appeals reversed a Tax Court decision in favor of the IRS and held that a publishing affiliate of a church qualified for exemption.

The Court found that “the principal issue this Court must address is at what point the successful operation of a tax-exempt organization should be deemed to have transformed that organization into a commercial enterprise and thereby to have forfeited its tax exemption.” This case helped lay the groundwork for the current understanding that it is acceptable for a nonprofit corporation to be successful.

The Court noted that “[i]t is doubtful that any small-scale exempt operation could ever increase its economic activity without forfeiting its tax-exempt status . . . “ if it were not allowed to make a profit. The Court decided that assuming there is no undue private inurement or benefit, the question is “what is the purpose of an organization claiming tax-exempt status.”

Some of the Court’s reasoning is helpful to understanding the underpinnings of how we think today about whether a Charity can profit from an exempt activity:

In order to come within the terms of § 501(c)(3), an organization seeking tax-exempt status must establish that it is organized “exclusively” for an exempt purpose.

. . . . Where a nonexempt purpose is not an expressed goal, courts have focused on the manner in which activities themselves are carried on, implicitly reasoning that an end can be inferred from the chosen means. If, for example, an organization’s management decisions replicate those of commercial enterprises, it is a fair inference that at least one purpose is commercial, and hence nonexempt. And if this nonexempt goal is substantial, tax exempt status must be denied. Clearly, petitioner’s conduct of a growing and very profitable publishing business must imbue it with some commercial hue. How deep a tint these activities impart can best be evaluated by looking at certain factors deemed significant in cases involving religious publishing companies, as well as in other pertinent cases.

. . . . P & R’s accumulation of “profits,” causes greater difficulty.

. . . . We do not read § 501(c)(3) or its legislative history to define the purpose of an organization claiming tax-exempt status as a direct derivative of the volume of business of that organization. Rather, the inquiry must remain that of determining the purpose to which the increased business activity is directed. As the Tax Court itself observed, “the presence of profit making activities is not per se a bar to qualification of an organization as exempt if the activities further or accomplish an exempt purpose.” *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202, 211 (1978). Despite the long history of § 501(c)(3) and the numerous organizations that have claimed its coverage, no regulation or body of case law has defined the concept of “purpose” under this provision of the Tax Code with sufficient clarity to protect against arbitrary, ad hoc decision-making. [Footnotes omitted]

There is no doubt that unexplained accumulations of cash may properly be considered as evidence of commercial purpose. . . . In light of the clear notice to the IRS of P & R’s need to expand its physical capacity, the claim that the accumulated profits would be used for this purpose, and the recognition by the IRS of such expansion as a legitimate reason for cash accumulation, we are unable to affirm the Tax Court’s determination that P & R’s cash-on-hand situation was a strong indicator of a non-exempt purpose.

. . . . Two competing policy considerations are present in situations where tax-exempt organizations begin to expand the scope of their profit-generating activities. On the one hand, the simple act of accumulating revenues may properly call into question the ultimate purpose of an organization ostensibly dedicated to one of the enumerated pursuits under § 501(c)(3). On the other hand, success in terms of audience reached and influence exerted, in and of itself, should not jeopardize the tax-exempt status of organizations which remain true to their stated goals.

Our concern is that organizations seeking § 501(c)(3) status may be forced to choose between expanding their audience and influence on the one hand, and maintaining their tax-exempt status on the other. If this were a stagnant society in which various ideas and creeds preserve a hold on a fixed proportion of the population, this concern would evaporate.

The publishing rulings and cases help us understand that a nonprofit corporation can make a profit as long as it operates in a non-commercial manner; that means, among other things, it selects its books for publication based on content, rather than salability, and it sells its books through non-commercial channels. Also any profits would have to be directed back towards the charitable or educational activity.

Publishing issues can become particularly complex where a nonprofit wants to publish some titles that would satisfy the above tests and some titles that would be purely commercial. Those situations present a challenge for the practitioner thinking about when it is necessary to split the activities into two corporations.

b. Conference centers. A recent case provides the IRS's current thinking on situations involving the operation of an exempt conference center. In *Airlie Foundation v. IRS* D. D.C. No. 02-0785 (EGS), (9/24/03), the Court laid out the following facts:

- Airlie carries out its mission principally by organizing, hosting, conducting, and sponsoring educational conferences on its facilities.
- It has played a role in the development of programs in areas as diverse as civil and human rights, international relations, public policy, the environment, medical education, mental health and disability.
- Airlie sponsors events such as lectures, concerts, and art shows free of charge and provides meeting space for non-profit organizations, overnight accommodations for participants of its cultural programs, and public use of its grounds for large-scale charitable events.
- On average, Airlie hosts about 600 groups per year. It derives approximately 85% of its operating revenue from fees paid by these clients and approximately 8% from its endowment. An average of 20% of Airlie's conference events are for government clients, 50% from nonprofit and/or educational clients, and 30%-40% for "other" users.
- At most, 10% of Airlie's clients use its facility for private events and another 10% at most represent private commercial clients pursuing their private interests. According to industry data from 1999, Airlie's average daily rate was almost 20% lower than the average rates for nearby conference centers.
- The expected operating pre-tax profit margin for a commercial conference center should be approximately 20% of gross revenues. Airlie's actual operations during the years 1995-1998 reflected a pre-tax profit margin of barely 4% after excluding grants, investment income and unusual items.
- In other words, the Foundation uses the investment income from its endowment to subsidize its conference and its other public benefit activities.

The Court noted that "only the operational test is at issue in this case." The operational test requires both that an organization engage "primarily" in activities that accomplish its exempt purpose and that not more than an "insubstantial part of its activities" further a non-exempt purpose. (citing Treas. Reg. (26 C.F.R.) §1.501(c)(3)-1(c)(1).) Though an incidental non-exempt purpose will not automatically disqualify an organization, 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." (*Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283, 66 S. Ct. 112 (1945); *Airlie*, 826 F. Supp. at 549.) In cases where an organization's activities could be carried out for either exempt or nonexempt purposes, courts must examine the *manner* in which those activities are carried out in order to determine their true purpose. (See, e.g., *Living Faith, Inc. v. Comm'r*, 70 T.C. 352, 356-57 (1978).)

The Court further noted that in applying the operational test, courts have relied on what has come to be termed the “commerciality” doctrine. In many instances, courts have found that, due to the “commercial” manner in which an organization conducts its activities, that organization is operated for nonexempt commercial purposes rather than for exempt purposes. The Court pointed out that “[a]mong the major factors courts have considered in assessing commerciality are competition with for profit commercial entities; the extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, *inter alia*, whether the organization uses commercial promotional methods (e.g., advertising) and the extent to which the organization receives charitable donations.”

In revoking the exempt status of the conference center, the Court reasoned as follows:

It is clear from the facts that plaintiff engages in conduct of both a commercial and exempt nature, the question whether it is entitled to tax-exempt status turns largely on whether its activities are conducted *primarily* for a commercial or for an exempt purpose. Parties are correct in asserting that *BSW Group, Inc. v. Comm’r*, 70 T.C. 352, 358 (1978), provides the most relevant case authority.

BSW Group involved the operation of a business purportedly formed for the purpose of providing consulting services primarily in the fields of rural-related policy and program development. Petitioner’s consulting clients were to be tax-exempt organizations and not-for-profit organizations that were to become aware of petitioner’s services through word of mouth rather than traditional advertisement. *BSW Group*, 70 T.C. at 354-55. Petitioner’s general policy was to provide its consulting services at or close to cost, but fees were to be sufficiently high as to enable petitioner to retain at least a nominal administrative fee over and above the amount payable to individual consultants. *Id.* at 355. In concluding, “with reluctance,” *id.* at 360, that *BSW Group* was not an exempt organization, the Tax Court focused on the fact that the organization’s “overall fee policy [was] ... to recoup its costs and ... realize some profit,” that the organization competed with commercial firms, that it had not received or solicited voluntary contributions, and that it had failed to limit its clientele to organizations which were themselves exempt under Section 501(c)(3). Notably, while petitioner’s fee structure in that case reflected ability to pay, it did not appear that the organization planned ever to charge a fee less than cost. *Id.* at 358-60.

In the present case, plaintiff admits that its primary activity is the operation of a conference center. Like petitioner in *BSW Group*, plaintiff acts as an intermediary and does not directly benefit the public. As was the case in *BSW Group*, plaintiff’s conference patrons are not limited to tax-exempt entities. According to the booking report for 1999, the year in which plaintiff applied to the IRS for tax exempt status, in fact, approximately 30%-40% of plaintiff’s patrons were of a private or corporate nature. While plaintiff in the instant case has made profits ranging from an average of 4% up to 10%, unlike petitioner in *BSW Group*, it provided more than 17% of its 1999 conferences for fees covering less than total costs. As the Tax Court correctly stated in the case of *IHC Health Plans, Inc. v.*

Comm'r, 325 F.3d 1188 (10th Cir. 2003), cited by defendant, “there is a qualitative difference between selling at a discount and selling below cost.” *IHC*, 325 F.3d at 1200. The fact that plaintiff’s conference center derives substantial income from weddings and special events and competes with a number of commercial, as well as non commercial, entities constitutes strong evidence, pursuant to *BSW Group*, of a commercial nature and purpose. Furthermore, though plaintiff contends that most of its bookings are the result of word-of-mouth referrals, it maintains a commercial website and has paid significant advertising and promotional expenses.

While plaintiff was organized for an exempt purpose, the Court cannot find, under the totality of the circumstances, that it is operated similarly. Having considered the facts before it, the Court is not persuaded that plaintiff has met its burden of demonstrating that an incorrect determination was made by the Internal Revenue Service. While certain factors-including plaintiff’s fee structure and subsidization practice-are indicative of non-commercial characteristics, others-such as the nature of its clients and competition, its advertising expenditures and the substantial revenues derived from weddings and special events on the premises, strongly suggest that the agency was correct in revoking the foundation’s tax exempt status.

The Airlie case may still be appealed, and so it is difficult to know whether the Court’s thinking will stand, but this case is interesting in that it illustrates the IRS’s position and at least one court’s position on the commerciality of conference centers, under the facts of the case.

3. Charitable

The 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 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 (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

There are many examples of charitable income generating activities – too many to consider for purposes of this paper. Let us examine four areas: (a) helping a charitable class by providing skills training, (b) low-income housing, (c) credit counseling, and (d) management and other consulting.

a. Job skills and training. The IRS recognizes that a Charity can further an exempt activity by being organized and operated to help a disadvantaged class of individuals learn how to perform a job skill. The disadvantaged class could be based on the 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.

b. Low-income housing. Low-income housing is a classic example of a revenue-generating activity that, if done correctly, should be charitable. But there are plenty of for-profit developers who also build and rent housing. What distinguishes one from the other?

Revenue Procedure 96-32, 1996-1 C.B. 717 (the "1996 Rev. Proc."), sets forth some of the safe harbors that a low-income housing organization may follow in order to qualify for exemption. It also describes the facts and circumstances that the IRS will consider if the organization cannot satisfy the safe harbor.

Traditionally, the IRS has recognized low-income housing as an exempt activity if it satisfies at least one of the following goals: combating community deterioration, lessening the burdens of government, elimination of discrimination and prejudice, lessening neighborhood tensions, relief of the distress of the elderly or physically handicapped.⁴

Relief of the poor and distressed. In a 1970 Revenue Ruling, 70-585, 1970-2 CB 115, the IRS described three situations in which an organization qualified for exemption and one in which it did not. In Situation 1, the organization provided new and renovated homes for sale to low-income families on long-term, low-payment plans. The activity of providing homes to low-income families who could not otherwise afford them was deemed to relieve the poor and distressed. In Situation 4, the organization provided rental housing to moderate-income families. This activity was not deemed to relieve the poor or distressed, because the families were of moderate income. These two situations clearly turn on the income level of the family receiving the housing. What is most notable about this revenue ruling is the omission of any discussion about what constitutes low income or moderate income, except a general statement that "the

⁴ These categories are described as "charitable" in Regulation Section 1.501(c)(3)-1(d)(2).

determination of what constitutes low income is a factual question based on all of the surrounding facts and circumstances.”⁵

Between 1970 and 1991, the IRS issued several rulings describing situations in which furnishing low-income housing serves to relieve the poor, but there was no attempt to articulate a comprehensive standard. For example, in GCM 36293 (May 30, 1975), the Chief Counsel found that an organization formed to aid low- and moderate-income families that qualified for assistance under a state mortgage loan program was insufficient to establish the relief of poverty. The organization in GCM 36293 was to provide housing in a predominantly white, non-contiguous suburb of a large metropolitan area. The organization proposed to offer 15 of its 60 units, representing 25% of its units, to low-income persons and between 20 and 30 of its units, representing 33% to 50% of the units, to moderate-income persons. The remainder of the units would be offered to others in order to support the fiscal viability of the project. There was no definition of low-income, other than to state that a local housing authority would help select the low-income tenants. The IRS found that the percentage offered to low-income persons was too low to qualify for relieving the poor and distressed, and the project failed to serve any other charitable purpose.

In Rev. Rul. 76-408, 1976-2 CB 145, the IRS held that an organization that provided loans in a badly deteriorating area to persons who qualified as “low-income” under standards promulgated by a government agency and who could not obtain loans elsewhere *was* engaged in the relief of the poor.

In October 1991, the IRS published its annual *Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* (“CPE”), a book which contains articles designed for the continuing education of IRS field personnel. One of the articles, authored by one of the principal draftsmen of the 1996 Rev. Proc., describes the then-current state of the law on “Low Income Housing as a Charitable Activity.”⁶ In this article, the authors summarize the outstanding rulings and cases and articulate, once again, an overall facts and circumstances approach, without the benefit of a safe harbor.

Community deterioration. An organization combats community deterioration by (1) operating in an area with actual or potential deterioration and (2) taking action to directly prevent or relieve that deterioration.⁷ Thus an organization can qualify even if it provides housing to moderate-income families in an area of a city that is deteriorating. In Situation 3 of Rev. Rul. 70-585, an organization was deemed to combat community deterioration. It acquired and renovated a housing project for rental to both low- and moderate-income families. The organization cooperated with a local redevelopment agency in providing residents with decent, safe, and sanitary housing. It also developed an overall plan for the rehabilitation of the area and sponsored a broad-based area renewal project in which residents participated.

⁵ Page 115.

⁶ Louthian and Friedlander, “Low-Income Housing as a Charitable Activity,” page 93.

⁷ 1996 Rev. Proc. Section 5.01(1), citing Rev. Rul. 68-17, 1968-1 CB 247, Rev. Rul. 68-655, 1968-2 CB 213, Rev. Rul. 70-585, 1970-2 CB 115 (Situation 3), and Rev. Rul. 76-147, 1976-1 CB 151.

In GCM 36293, the Service reaffirmed that an organization that combats actual or even potential deterioration in a community can qualify for exemption. “Any systematic and reasonably effective program that is carried on for the sole purpose of helping the low-income victims . . . move into better living quarters, and thereby reducing or eliminating municipal squalor, would thus appear to come within . . . [the definition of charitable] which refers to combating community deterioration and juvenile delinquency.”

In an article in its 1994 CPE (October 1993), the IRS listed some factors it has relied upon in some exemption applications that adequately demonstrated the presence of community deterioration. These include: the income level of the residents; the age of the housing stock; unemployment in the area; location of the project in relationship to parks or other areas for diversion; comparative housing costs (because declining housing costs help identify an area in decline); the amount of crime in an area; the level of drug trafficking; the presence and amount of graffiti; the percentage of homes below city code standards.⁸

Lessening the burdens of government. An organization lessens the burdens of government if (a) there is an objective manifestation by the governmental unit that it considers the activities of the organization to be the government’s burden, and (b) the organization actually *lessens* the government’s burdens.⁹ The federal and state governments have traditionally accepted the burden of providing or subsidizing housing to low-income families, and nonprofit organizations have worked closely with the government agencies to provide that housing. For example, in PLR 9411037, the IRS found that an organization that draws funds from a city’s housing development fund to aid the city in providing low- and moderate-income housing was lessening the burdens of government. Presumably, if federal and state governments cut back on their housing assistance to low-income families – for example, through a reduction in or elimination of HUD programs – nonprofits will be called upon to assume these traditionally governmental functions.

Elimination of discrimination. Elimination of discrimination and prejudice is a further charitable purpose. The rulings in this area describe organizations that seek to eliminate discrimination by assisting persons in specific racial groups to acquire housing for the purpose of stabilizing neighborhoods or reducing racial imbalances.¹⁰

Lessening neighborhood tensions. The 1996 Rev. Proc. indicates that lessening neighborhood tensions is generally identified as an additional charitable purpose by

⁸ 1994 CPE, page 133.

⁹ 1996 Rev. Proc. Section 5.01(2), citing Rev. Ruls. 85-1 and 85-2, 1985-1 C.B. 178. See also Louthian and Henchey, “Lessening the Burdens of Government,” *Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* for FY 1992 (1991), p. 18.

¹⁰ 1996 Rev. Proc. Section 5.01(3), citing Rev. Rul. 68-655, 1968-2 C.B. 213, and Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 2).

organizations that fight poverty and community deterioration associated with overcrowding in lower income areas in which ethnic or racial tensions are high.¹¹

Relief of the distress of the elderly or handicapped. The 1996 Rev. Proc. indicates that some organizations provide housing specifically for the elderly or physically handicapped, and these organizations generally seek exemption under the standards set forth in Rev. Rul. 72-124, 1972-1 C.B. 145, Rev. Rul. 79-18, 1979-1 C.B. 194, and Rev. Rul. 79-19, 1979-1 C.B. 195.

In order to make it easier for low-income housing organizations to qualify for exemption, the IRS issues a safe harbor:

The safe-harbor. Under the 1996 Rev. Proc., an organization will be considered charitable if it satisfies each of the following four requirements:

1. *An Income Test.*¹² The organization must establish for each project that:
 - (a) at least 75% of the units are occupied by residents that qualify as low-income. Low income is defined in accordance with the income limits computed and published by the Department of Housing and Urban Development (“HUD”) in Income Limits for Low and Very Low-Income Families Under the Housing Act of 1937. The term “low income” is defined by that Act as 80% of the area median income. *And*
 - (b) either at least 20% of the units are occupied by residents that also meet the very low-income limit for the area **or** 40% of the units are occupied by residents that also do not exceed 120% of the area’s very low-income limit. The term “very low income” is defined under the Housing Act of 1937 as 50% of area median income. In addition, up to 25% of the units may be provided at market rates to persons who have incomes in excess of the low-income limit.

2. *An Occupancy Test.* The project must actually be occupied by those poor and distressed residents described under the income test. With new construction, a reasonable start-up period is allowed before an organization must meet this requirement. For acquisition transactions, the transition period to satisfy this requirement will be assumed to be reasonable if the transition is completed within one year. If a project operates under a government program that allows a longer transition period, then this longer period will be used to determine reasonableness.

3. *An Affordability Test.* The housing must be affordable to the charitable beneficiaries. This requirement will ordinarily be satisfied by the adoption of a rental policy that

¹¹ 1996 Rev. Proc. Section 5.01(4), citing Rev. Rul. 68-655, 1968-2 C.B. 213, and Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 2).

¹² The 1996 Rev. Proc. does not use headings to describe the tests; headings have been supplied by the author.

follows government-imposed rental restrictions or a rental policy that otherwise provides for the relief of the poor and distressed. Typical government programs require that rents be set at 30% of the applicable income limit.

4. *Multiple Buildings.* If the project consists of multiple buildings, they must share the same grounds.

In addition, the IRS will, in applying this safe harbor, follow these guidelines:

- (1) The IRS will apply HUD guidelines on income limits for low-income and very low-income families. Recognizing the current climate in Congress, the 1996 Rev. Proc. provides that if HUD's program terminates, the Service will use income limits computed under such program as is in effect immediately before such termination. Although the 1996 Rev. Proc. does not so state, presumably these limits would be inflation-adjusted.
- (2) The retention of the right to evict tenants for failure to pay rent or other misconduct will not, in and of itself, cause the organization to fail to meet the safe harbor.
- (3) An organization originally meeting the safe harbor will continue to satisfy the requirements of the safe harbor if a resident's income increases, provided that the resident's income does not exceed 140% of the applicable income limit under the safe harbor. If the resident's income exceeds 140% of the qualifying limit, the organization will not fail to meet the safe harbor if it rents the next comparable non-qualifying unit to someone under the qualifying income limits.
- (4) To be considered charitable, an organization that provides assistance to the aged or physically handicapped who are not poor must satisfy the requirements set forth in Rev. Rul. 72 124, 1972-1 C.B. 145, Rev. Rul. 79-18, 1979-1 C.B. 194, and Rev. Rul. 79-19, 1979-1 C.B. 195. If an organization meets the safe harbor, then it does not need to meet the requirements of these rulings, even if all of its residents are elderly or handicapped residents. However, an organization may not use a combination of elderly or handicapped persons and low-income persons to establish the 75% occupancy requirement of the safe harbor. An organization with a mix of elderly or handicapped residents and low-income residents may still qualify for tax-exempt status under the facts and circumstances test.

Finally, the 1996 Rev. Proc. states that even if an organization satisfies the safe harbor, it may nevertheless fail to qualify for exemption because private interests of individuals with a

financial stake in the project are furthered.¹³ For example, the IRS will examine the role of a developer or management company in the organization's activities, as well as any private benefit resulting from property sales, development fees, and management fees. Interestingly, there is no discussion at all in the 1996 Rev. Proc. about a nonprofit's involvement in a limited partnership that provides housing but that also offers tax credits and other tax benefits to its limited partners.

Facts and circumstances alternative. If an organization cannot qualify for exemption under the safe harbor, it may still qualify if it can show that it relieves the poor and distressed by reference to all of the surrounding facts and circumstances. The Service discussed the facts and circumstances alternative briefly in October 1993, in response to comments from practitioners and charities to the 1993 guidelines. These facts and circumstances are articulated in substantially more detail in the 1996 Rev. Proc. The 1996 Rev. Proc. identifies the following ten facts and circumstances that the IRS will, at minimum, consider to be relevant in granting an exemption:

- (1) A substantially greater percentage of residents than required by the safe harbor with incomes up to 120% of the area's very low-income limit. (This factor suggests that if a charity cannot provide 75% of its units to families at 80% of the area median income, it will be in a better position if it can provide more than 40% to residents at 120% of the very low-income level.)
- (2) Limited degree of deviation from the safe harbor percentages.
- (3) Limitation of rents to ensure that they are affordable to low-income and very low-income residents.
- (4) Participation in a government housing program designed to provide affordable housing. (The IRS now explicitly recognizes participation in a government program to be a relevant fact).
- (5) Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations.
- (6) The provision of additional social services affordable to the poor residents.
- (7) Relationship with an existing 501(c)(3) organization active in low-income housing for at least five years if the existing organization demonstrates control. (This factor presumably would help new corporations that are established to serve as the general partner of a limited partnership. Those new corporations that are controlled by established nonprofit housing providers will be more likely to qualify for exemption).

¹³ 1996 Rev. Proc. Section 6.

- (8) Acceptance of residents who, when considered individually, have unusual burdens, such as extremely high medical costs, which cause them to be in a condition similar to persons within the qualifying income limits in spite of their higher incomes.
- (9) Participation in a home ownership program designed to provide home ownership opportunities for families that cannot otherwise afford to purchase safe and decent housing.
- (10) Existence of affordability covenants or restrictions running with the property.

There is nothing surprising or unusual about these facts and circumstances. It was important, however, for the IRS to set forth these facts and circumstances, because they do provide organizations that are trying to qualify for exemption with a clearer idea of how to structure their projects in situations in which they cannot meet the safe-harbor guidelines.

In the 1996 Rev. Proc., the IRS provides some concrete examples applying these facts and circumstances. In the six examples provided, three demonstrate facts and circumstances that qualify the organization for exemption:

Example 1: Organization N operates pursuant to a government statute to preserve low- and moderate-income housing projects. Seventy percent of its residents have incomes that do not exceed the area's low-income limit. Fifty percent of its residents have incomes that are below the area's very low-income limit. N restricts rents to residents below the qualifying income limits to no more than 30% of the residents' incomes. N is close to meeting the safe harbor. N has a substantially greater percentage of very low-income residents than required by the safe harbor; it participates in a federal housing program; and it restricts its rents.

Example 2: Organization O will finance a housing project using tax-exempt bonds pursuant to Section 145 (d) of the Code. O will meet the 20-50 test under Section 142(d)(1)(A). Another 45% of the residents will have incomes at or below 80% of the area's median income. The final 35% of the residents will have incomes above 80% of the median income. O will restrict rents to residents below the qualifying income limits to no more than 30% of the residents' incomes. O will provide social services to project residents and to other low-income residents in the neighborhood. Also, O will purchase its project through a government program designed to retain low-income housing stock.

Example 3: Organization R provides home ownership opportunities to purchasers determined to be low-income under a federal housing program. Beneficiaries under the program cannot afford to purchase housing without assistance, and they cannot qualify for conventional financing. R's residents will have the following composition: 40% will not exceed 140% of the very low-income limit for the area, 25% will not exceed the low-income limit, and

35% will exceed the low-income limit but will not exceed 115% of the area's median income.

c. Credit counseling. Recently, the IRS has been focusing on income generated from credit and debt counseling repair services. See, for example, "Credit Counseling Organizations, By Debra Cowen and Debra Kaweck, Exempt Organizations Continuing Professional Education (CPE) Technical Instruction Program for Fiscal Years 2003 and 2004," which is available on the IRS website. Credit counseling is a good example of an area that has evolved from a purely charitable endeavor to something that is often not exempt because nonprofits saw income-generating opportunities.

In 1960, a credit counseling service (agency) was recognized as exempt under IRC 501(c)(3) in Rev. Rul. 69-441, 1969-2 C.B. 115. This agency limited its services to low-income individuals and families with financial problems. Its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions. The IRS changed its mind in the mid-1970's and decided that credit counseling was not a 501(c)(3) activity, although it did enhance social welfare and could qualify under Section 501(c)(4).

In two court cases, the courts upheld the 501(c)(3) status of two organizations and rejected the IRS's arguments for revocation. *Consumer Credit Counseling Service of Alabama v. United States*, 78- 2 U.S.T.C. 9660 (D.D.C. 1978) and *Credit Counseling Centers of Oklahoma, Inc. v. United States*, 79-2 U.S.T.C. 9468 (D.D.C. 1979).

In these cases, the IRS argued that the two agencies were not organized and operated exclusively for charitable or educational purposes; the debt management services were not limited to low-income individuals or families; fees were charged for the services rendered. The courts did not agree with the IRS, and held that the two organizations were charitable and educational in nature as described in IRC 501(c)(3). Providing information regarding the sound use of consumer credit is charitable because it advances education and promotes social welfare within Reg. 1.501(c)(3)- 1(d)(2). These programs are also educational because they instruct the public on subjects useful to the individual and beneficial to the community. Reg. 1.501(c)(3)- 1(d)(3)(i)(b).

The direct customer counseling assistance programs were likewise charitable, the court found, and educational in nature. The court also looked at the debt management and creditor intercession activities as an integral part of the two agencies' counseling function.

More recently, however, the IRS is once again challenging credit counseling agencies' tax-exempt status. The IRS feels that the industry has evolved and agencies are spending significantly less time on counseling and education and significantly more time on negotiating down debt of individual clients with credit card companies and taking a fee for that service. This, the IRS believes, is too commercial. It remains to be seen in the near future how these cases evolve.

d. 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 set 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.¹⁴

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.¹⁵ 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

¹⁴ See IRC 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.

¹⁵ 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.

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.¹⁶

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 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 (1) 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

¹⁶ See, for example, UBIT analysis in Priv. Ltr. Rul. 9617031.

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.¹⁷

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 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. Rev. Rul. 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

¹⁷ See also Priv. Ltr. Rul. 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.

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 not charitable).

The nature and scope of the services – the presence of competition. 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 Service 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); Priv. Ltr. Rul. 9347033¹⁸ (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).¹⁹

¹⁸ While private letter rulings do not constitute precedential authority, we cite them here as an example of the IRS’s analysis of these issues.

¹⁹ 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; (vii) assessment of grant impact.

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.²⁰ 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.

Similarly, in *Iowa State University of Science & Technology v. United States*,²¹ the court evaluated whether the operation of a commercial television station by a state university was a related trade or business. The court observed that "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."²² 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.

We have now examined several areas in which the IRS and the courts permit a Charity to generate income from providing exempt services or products under certain conditions. There are, of course, as many examples as there are creative minds. As the nonprofit sector becomes more and more entrepreneurial, we are likely to see more and more interesting cases and rulings on this topic.

²⁰ 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).

²¹ *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).

²² *Iowa State Univ. of Science & Tech. v. United States*, 500 F2d 508, 517 (Ct. Cl. 1974).

III. UNRELATED BUSINESS TAXABLE INCOME

A. Introduction

If a Charity's activities are not in furtherance of an exempt purpose, then we have two related questions to address: First, do the activities generate taxable income (this Section III), and second, 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

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 Internal Revenue Code generally do not pay taxes on the income that they generate. There are two significant exceptions: private foundations pay a 2%, or sometimes 1%, tax on their investment income,²³ and any Section 501(c) organization with UBTI pays UBIT on that income at the regular corporate tax rates.²⁴

1. 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.²⁵

a. 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."²⁶ 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.²⁷ Although

²³ Code Sec. 4940.

²⁴ Code Sec. 511.

²⁵ 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.

²⁶ Code Sec. 513(c); Reg. 1.513-1(b).

²⁷ Code Sec. 1.513-1(b).

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 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.

b. 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.”²⁸

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. 1.513-1(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

²⁸ Reg. Sec. 1.513-1(c).

acquiesced in this decision (AOD 1249, March 22, 1984), but it is not clear that the IRS would reach a similar conclusion today.

c. 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.²⁹
- In PLR 200021056, the Service 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.

²⁹ See, e.g., Tech. Adv. Mem. 95550003 (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.

- In PLR 200032050 the Service considered a question which exempt organizations pose from time to time: Can an organization rent real estate (debt financed) to other 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.³⁰

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.

2. 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. 9Code Sec. 512(b)(1).)
- Royalties. 9Code 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 a lease involves more personal property than real estate, if the rental income is based at all on the net income or profits of the tenant, or if 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.

³⁰ See also Rev. Rul. 69-572, 1969-2 C.B. 119.

- 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.
- 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).)

3. 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.³¹
- 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.

4. Other UBIT issues

There are a series of other UBIT issues that arise and that are not addressed in this outline. For example, special rules apply to income distributed from a partnership or S-corporation.³²

³¹ 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.

³² See Code Secs. 512(c) and 512(e).

5. Mailing lists and affinity credit cards

In the past four or five years, 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:

a. 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.³³

³³ 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.³⁴

b. 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 Service. (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’s all-or-nothing approach – that any services tainted the entire arrangement. Judge Kleinfeld stated that “[v]iewed purposively, the royalty exclusion cannot be an all-or-nothing proposition.” The Court further noted that “[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

³⁴ 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.

the two years at issue pursuant to the contracts with the bank.” The Court 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.³⁵ 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.

6. Corporate sponsorship

a. History. Sponsorship in some form or another had 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 Service 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 Service’s position in the TAMs.³⁶ Perhaps concerned in part that public opinion would cause Congress to pass legislation in opposition to the Service’s 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.³⁷ These regulations permit the type of activity that was found to be taxable in the earlier TAMs.

b. 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.

³⁵ See comments in *28 Exempt Organization Tax Review*, pp. 18-19 (April 2000).

³⁶ Ann. 92-15, 1992-5 IRB 51.

³⁷ EE-74-92, Jan. 22, 1993.

Under Section 513(i), an exempt organization's solicitation and receipt of qualified sponsorship payments" (QSPs) 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 Service continues to apply the rule of the *American College of Physicians* 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.

c. Regulations. On April 25, 2002, Treasury 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).

B. 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 workplan indicates 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 some 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.³⁸ 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 pages 32-33 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 Service 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 Service 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 doesn’t 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.³⁹

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.

³⁸ Reg. 1.513-1(c).

³⁹ 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.

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.⁴⁰ Even if all three tests are satisfied, exceptions and modifications under Section 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, because if the book is substantially related, it is always substantially related.

3. Are there any circumstances under which an online “virtual trade show” qualifies as an activity of a kind “traditionally conducted” at trade shows under section 513(d)?

Section 513(d) of the Code exempts certain trade shows from UBIT. Some Section 501(c)(6) trade associations and other exempt organizations are attempting to replicate the trade show in the virtual format. These organizations typically receive income from virtual exhibitors as well as from other corporate sponsors of the event.

IRC 513(d) and Reg. 1.513-3(b) provide that certain traditional convention and trade show activities carried on by a qualifying organization in connection with a qualified convention or trade show will not be treated as UBIT.

A qualifying organization is one described in Section 501(c)(3), (4), (5), or (6), which regularly conducts, as one of its substantial exempt purposes, a qualified convention or trade show activity. A qualified convention or trade show activity is any activity of a kind

⁴⁰ Reg. 1.513-1.

traditionally carried on by a qualifying organization in conjunction with an international, national, state, regional, or local convention or annual meeting or show if:

- (a) One of the purposes of the organization in sponsoring the activity is promoting and stimulating interest in, and demand for, the products and services of that industry, or educating the persons in attendance regarding new products and services or new rules and regulations affecting the industry, and
- (b) The show is designed to achieve its purpose through the character of the exhibits and the extent of the industry products that are displayed.

If these requirements are satisfied, rental income from exhibitors at a trade show is not UBIT. Qualified convention and trade shows are specifically excepted from the Section 513(i) corporate sponsorship safe harbor because this separate set of rules applies. Presumably, an “unqualified” trade show could still have elements, such as pure sponsorships, that satisfy the corporate sponsorship safe harbor.

Any virtual trade show that satisfies the above criterion should qualify for the UBIT exemption under Section 513. The current law, however, simply does not contemplate a virtual trade show, and the rules are very much drafted with a view towards the traditional live trade show that is conducted annually or periodically. The Code even refers to an “activity of a kind traditionally carried on”

Ideally, Congress would amend Section 513(d) to conform with the current reality of on-line trade shows. Tradition is changing, and income received during these types of shows should be exempt. Working within the current legal framework, however, it would be helpful for the IRS to acknowledge that a virtual trade show that meets the two tests described above would qualify as a trade show exempt from UBIT.

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 that otherwise appears to be corporate sponsorship, take the acknowledgment out of the corporate sponsorship safe harbor because it constitute 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.

The presence of a link to a corporate sponsor on a nonprofit’s website has been analogized to listing a telephone number,⁴¹ 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.⁴² However, the IRS in its Year 2000 CPE Text also stated that a link

⁴¹ See “D.C. Bar Internet Discussion Featured IRS’s Bob Harper,” 5 EO Tax J. 36 (December 1999/January 2000) (“EO Tax J.”).

⁴² Ltr. Rul. 9723046.

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.⁴³ 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.⁴⁴

The Regulations provide two helpful examples. The first example describes a symphony orchestra that acknowledges a sponsor on its website.⁴⁵ 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 EO's website will not result in attribution of the content at the linked site to the EO 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.⁴⁶ 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, although easier to access, is conceptually just like a phone number. The user must take the affirmative step of contacting the sponsor.

The IRS has indicated, at least informally, that it may not ultimately agree with this conclusion, because it is easier for a user to click on a link than to pick up the phone and dial. The IRS will likely focus instead, therefore, on the nature of the link. If the link, for example, takes the user to the corporation's home page, then the link will not change the nature of the

⁴³ Exec. Assistant Jay Roots, 4 EO Tax J. 26 (July/August 1999).

⁴⁴ 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."

⁴⁵ See Treas. Reg. § 1.513-4(f), Example 11.

⁴⁶ See Treas. Reg. § 1.513-4(f), Example 12.

sponsorship. If the link takes the user directly to a page on the sponsor's website that affords the user the ability to purchase a product, the IRS feels the link is more akin to advertising.⁴⁷

In addition, the IRS had at one time informally indicated that moving banners might, per se, be advertising. The IRS informal position now seems to be that we look to the content of the banner to see if it satisfies the corporate sponsorship safe harbor. If it does, the fact that it moves is irrelevant. Links in moving banners would be considered in the same way as links in other sponsorship statements, as discussed above.

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 which 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.⁴⁸

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 which conduct their own online 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.

This Section III has considered situations in which income from an activity might be taxable or not taxable as unrelated business income. Section IV addresses the next logical question.

⁴⁷ See "Update on Internet Tax Issue for Exempt Organizations," Robert Harper and Cherly Chasin. October 20, 2000, as part of a conference titled "Advising Nonprofit Organizations in Colorado," sponsored by the Colorado and Denver Bar Associations.

⁴⁸ 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 how much unrelated activity it may engage in? 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.⁴⁹

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].⁵⁰

⁴⁹ 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.

⁵⁰ *Taxation of Exempt Organizations*, Hill and Mancino, Warren, Gorham & Lamont of RIA, pages 21-17 through 21-18, updated regularly.

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 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.

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.” Another very different model, using a limited liability company or partnership, is discussed in Section VI.

Option A: Keeping the unrelated activity within the existing Charity.

Advantages:

- If Charity has a net loss from 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 file returns for.
- 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, 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 the 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 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.

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, and finally, 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.

VI. LIMITED LIABILITY COMPANIES AND PARTNERSHIP

Limited liability companies (“LLC”) and both general partnerships and limited partnerships are treated the same way for tax purposes. Unlike a corporation, that pays tax at the corporate level, a partnership or LLC passes its income and expenses through to its partners or members, and they pay tax on the income at the partner or member level.⁵¹ The 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 this Section, we explore, only briefly, when an LLC or partnership might or might not be an appropriate vehicle for a business activity of a Charity.

First, it is worth noting that sometimes a Charity will consider forming a partnership or an LLC to operate an exempt activity that could have been operated directly by the Charity. As an example, Charities will typically form partnerships or limited liability companies to operate low-income housing projects where the for-profit investors can take advantage of certain low-income housing tax credits. Although the for-profit investors pay taxes on their share of any income, the Charity does not, because the operation of the low-income housing project, if structured correctly, is part of the exempt activity of the Charity.

There has been quite a volume of case law recently over when an activity with a limited liability company that has both exempt and non-exempt members, particularly in the hospital context, is considered an exempt activity for the Charity member. These issues are still being litigated. For many years, the IRS took the position that a 501(c)(3) organization could not participate as a general partner in a partnership having private investors as limited partners, even if the underlying activity was charitable or educational in nature. The IRS believed that such participation was *per se* incompatible with maintaining the organization’s tax-exempt status. The IRS’s position has been evolving ever since the Tax Court decision in *Plumstead Theatre Society Inc.*, 74 TC 1324 (1980), *aff’d per curiam*, 675 F.2d 244 (9th Cir. 1982). In that case, a nonprofit theater company was permitted to serve as the general partner of a limited partnership that had private investors as limited partners without losing its Section 501(c)(3) status, because the partnership’s primary activity (which was to finance the Theatre Society’s co-production of a play) was considered to be substantially related to and in furtherance of the exempt participant’s charitable, educational purposes.

The IRS’s *per se* position was replaced by a facts-and-circumstances analysis under which “careful scrutiny” of the facts was required. Under this “careful scrutiny” test, in order to

⁵¹ Actually, partnerships and LLC’s can elect to be taxed either as partnerships or as corporations, but most elect partnership tax treatment.

preserve the exempt participant's tax-exempt status, first it must be determined that the partnership is serving or furthering a charitable or other exempt purpose, and second, it must be determined that the partnership arrangement permits the exempt participant to act exclusively in furtherance of its own exempt, charitable purposes and not just for the benefit of private, for-profit partners.⁵²

In 1998, the IRS issued Revenue Ruling 98-15 in response to a growing trend in the hospital industry towards "whole hospital" joint ventures, which involve the contribution of an entire hospital system to a new partnership or LLC, with a for-profit partner or co-member. In Rev. Rul. 98-15, 1998-1 C.B. 718, the IRS analyzed two situations. In Situation 1, the IRS found that the organization continued to qualify for exemption. In situation 2, it did not. Many of the factors in both Situation 1 and Situation 2 were similar. The key distinguishing factor was control. In Situation 1, the nonprofit appointed more than half of the LLC governing body. In Situation 2, the for-profit and the nonprofit each appointed half the governing body.

The IRS has also litigated at least two significant cases involving whole hospital joint ventures. In *Redlands Surgical Services v. Comm.*, 113 TC 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001), focusing largely on the second prong of the "careful scrutiny" test under which the exempt participant must be permitted to act exclusively in furtherance of its exempt purposes, the IRS was able to persuade the Tax Court that the overall facts and circumstances did not favor the nonprofit's charitable mission.

Even more recently, in the case of St. David's hospital systems, the United States District Court for the Western District of Texas found, among other things, that the IRS's "control" test was not dispositive of the issue and that the 501(c)(3) in that case should maintain its tax-exempt status. (89 AFTR2d 2002-2998 (Dist. Ct. Tex, 2002).) This case was very recently overturned on appeal, however, on November 7, 2003, by the 5th Circuit, and so the future of this whole issue is very much unclear.

The hot cases discussed above focus on the situation in which a Charity is dropping its entire activity into an LLC that involves for-profit investors. If, on the other hand, a Charity is not trying to claim that the LLC or partnership is furthering the exempt purposes of the Charity, but rather is an ancillary money-making investment for the Charity, can a Charity use an LLC or partnership to carry out this work, while still maintaining its core exemption? The answer should be "yes," but this area of law is still a bit unsettled, and we would normally recommend using a corporate subsidiary, rather than an LLC. 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.

⁵² GCM 39005, 6/28/83; GCM 39444, 11/13/85; GCM 39546, 8/15/86.

- 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 the Charity. Thus, it may not be a useful tool for moving a substantial business activity out of the charity.
- Start-up costs to form new organization; ongoing costs of maintaining two separate corporations is higher.
- All net income from the LLC or partnership will be passed through to the 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.

VII. FORMING SUBSIDIARIES – THE MECHANICS

Sections V and VI reviewed some of the advantages and disadvantages of forming different types of entities. This Section is designed to review some of the mechanics and practical decision points, once the overall strategy has been established.

- An exempt organization can form a nonprofit subsidiary if the primary purpose and activity of the subsidiary is a tax-exempt one. Formation of the nonprofit subsidiary involves:
 - Preparation and filing of Articles of Incorporation
 - Appointing the initial Board of Directors
 - Adoption of Bylaws, which includes provisions which specify the level of control the parent has over the subsidiary
 - Tax-exemption applications
 - Capitalization of the subsidiary
 - Development of any contracts between parent and subsidiary
- An exempt organization can form a for-profit subsidiary. It can own 100% of the stock, or it can sell shares to others. The sale of shares can be helpful for raising capital, but involves securities law issues and other issues beyond the scope of this presentation. Formation of a wholly owned for-profit subsidiary involves:
 - Preparation and filing of Articles of Incorporation
 - Adoption of Bylaw
 - Appointing the initial Board of Directors
 - Issuance of stock and compliance with securities laws
 - Capitalization of the subsidiary
 - Development of any contracts between parent and subsidiary

- Another form of for-profit “subsidiary” is the wholly owned, limited liability company (LLC). An LLC is formed by drafting an LLC agreement and filing an appropriate certificate with the Secretary of State’s office. When structuring an LLC, one must consider at least the following issues:
 - Who will control the LLC?
 - How will profits and losses be allocated?
 - What is the term of the LLC, which unlike a corporation has a specific term?

VIII. FLOW OF FUNDS

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 the 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, the Charity owns at least 51% of the stock.
- In the independent corporation model, or “IC” model, the Charity owns less than 51% of the stock.
- The 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 the Charity’s exempt purposes.

A. Capitalizing the entity

The entity will need some combination of capital contributions and loans from the Charity and other investors, if any. Normally, a Charity can make a capital contribution or loan to a Sub, an IC, or an LLC with no immediate tax consequences. The Charity must make sure, however, that it receives fair value in return for its contribution or loan. Therefore, if there are other investors, the Charity must receive stock or LLC interest with a fair market value equal to the amount it contributes. Since it is very difficult to value stock in a new entity, we would look mostly to the relative value of what the 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? See Sections V and VI above.
7. Mechanically, how do we set up the new organization? See Section VII above.
8. How will the flow of funds be taxed? See Section VIII above.