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Unrelated Business Income Tax: A Primer

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I. Unrelated Business Taxable Income

A. Introduction

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

This outline provides a basic overview of how UBIT works and summarizes some of the most significant developments in this area of tax law.

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.[3]

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."[4] The Federal Income Tax Regulations (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.[5] Although there have been cases that analyze the "trade or business" element of the test, and although it is possible to have an income-generating activity that is not a "trade or business," as a practical 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."[6]

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

- It is important to compare the frequency and continuity of the activity with comparable activities being carried on by commercial entities. (Reg. 1.513-1(c)(1).) For example, if an activity is inherently seasonal, such as horseracing, then the regularity must be determined by examining the normal time span of comparable commercial activity. (Reg. 1.513-1(c)(2)(i).)
- An activity carried on one or two weeks a year is not likely to be regularly carried on, especially if other taxable entities engage in the same activity on a more regular basis. (Reg. 1.513-(c)(2)(i).)
- An activity carried on once a week, such as the operation of a commercial parking lot, each week of the year, is regularly carried on. (Reg. 1.513-1(c)(2)(i).)
- Annual or semi-annual fundraisers are typically not regularly carried on, even though they occur every year.
- In *NCAA v. Commissioner* 914 F.2d 1417 (10th 1990), the Court held that advertising in the NCAA program was not a regular activity, because the tournament had a very limited two- to three-week duration, even though the NCAA spent much of the year selling the advertising space. The IRS does not follow this case, and it is probably not prudent to rely on this case, especially outside of the 10th Circuit.
- In *Suffolk County Patrolmen's Benevolent Association* 77 T.C. 1314 (1981), the Court found that the production of an annual vaudeville show conducted over eight to sixteen weeks, including a printed program for the show that accepted advertisements, was not regularly carried on, even though the activities were conducted by professional fundraisers over a six-month period. The IRS acquiesced in this decision (AOD 1249, March 22, 1984), but it is not clear that the IRS would reach a similar conclusion today.

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 Regulations addressing 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.[7]
- 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.
- 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.[8]

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. Code Sec. 512(b)(1).)
- Code Sec. 512(b)(2).) Much of the discussion in connection with affinity credit cards has involved the definition of a royalty. These arrangements are described below.
- Rents derived primarily from real estate and a limited amount of personal property leased with the real estate. (Code Sec. 512(b)(3).) This exception does not apply if 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.
- 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, these items, when received from an entity that the exempt organization "controls," generally are taxable, except as described below. This section 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. In 2006, Congress provided that for interest, rent, annuity or royalty payments (i) received or accrued during the calendar years 2006 and 2007 and (ii) made pursuant to a binding written contract in effect on August 17, 2006 (or a renewal of such a contract on substantially similar terms), only the portion of any interest, rent, annuity, or royalty payment from a controlled entity that *exceeds* fair market value is subject to the unrelated business income tax, plus a 20% penalty on the excess payment.[9] At present, this provision will apply only to payments received or accrued on or before December 31, 2009.
- 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.[10]

5. **Mailing lists and affinity credit cards**

The IRS previously 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 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. 86 F.3d 1526 (9th 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.[11]

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.[12]

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 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 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.[13] 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.[14] 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.[15] 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.

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.[16]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 2-3 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.[17]

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

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

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

In order for income to be taxable, the income must be from an activity that is trade or business, that is regularly carried on (discussed above), and that is not substantially related to the organization's exempt purpose.[18] 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 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,[19] 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.[20] However, the IRS in its Year 2000 CPE Text also stated that a link which is related to the exempt organization's purposes or activities may not be advertising, and one IRS official has indicated that unless a link generates income, it would probably not be deemed to constitute advertising.[21] 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.[22]

The Regulations provide two helpful examples. The first example describes a symphony orchestra that acknowledges a sponsor on its website.[23] 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.[24] 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 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.[25]

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.[26]

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.

II. 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. 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. [27]

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.[28]

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. Creating a for-profit subsidiary is beyond the scope of this outline, but we would be happy to discuss this option.

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[1] Code Sec. 4940.

[2] Code Sec. 511.

[3] This outline 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.

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

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

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

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

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

[9] See Code Section 512(b)(13)(E).

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

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

[12] 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.

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

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

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

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

[17] See TAM 9550003 and TAM 9720002 discussing the unrelated business taxable income characterization of items sold at a museum gift shop; see also a discussion of this matter in the 1997 and 1999 CPE texts.

[18] Reg. 1.513-1.

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

January 2000) ("EO Tax J.").

[20] Ltr. Rul. 9723046.

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

[22] 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."

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

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

[25] 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.

[26] 2000 CPE Text, *supra* n. 12, at 138.

[27] 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.

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