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Planning Techniques for
Avoiding UBIT

By

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I. Introduction.

A. Overview of Law. The Internal Revenue Code imposes a tax at normal corporate or trust rates on the unrelated business taxable income ("UBTI") of most exempt organizations.[1] Generally speaking, UBTI is the net profit earned by an exempt organization from activities that are not related to its exempt purposes. First enacted in 1950, the purpose of the unrelated business income tax ("UBIT") is to eliminate any unfair competitive advantage that exempt organizations may have over their for-profit counterparts by imposing a tax on business activities that are not related to their exempt purposes.

B. Tax Planning to Avoid UBIT. There are many opportunities to reduce or eliminate UBIT-- so many, that it has been referred to as the "voluntary tax."[2] This outline examines a number of approaches to avoiding or reducing UBIT, ranging from relatively simple strategies to sophisticated tax planning. The following topics are covered.

1. Activities that are not within the definition of an unrelated trade or business. I.R.C. § 513.

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[1] I.R.C.§ 511. The UBIT applies to most, though not all, organizations exempt from tax under section 501(a) of the Code, including: charitable, religious, scientific and other organizations described in section 501(c); employees' trusts forming part of pension, profit-sharing, and stock bonus plans described in section 401(a). UBIT also applies to: individual retirement accounts ("IRAs"), including traditional IRAs, Roth IRAs, education IRAs, simplified employee pensions (SEP-IRAs), and savings incentive match plans for employees (SIMPLE IRAs); state and municipal colleges and universities; qualified state tuition programs; and medical savings accounts described in section 220(d). UBIT does not apply to U.S. instrumentalities described in section 501(c)(1) of the Code. (All section references in this outline are to the Internal Revenue Code of 1986, *as amended*, unless otherwise indicated.)

[2] *See* Evelyn Brody and Joseph Cordes, *The Unrelated Business Income Tax: All Bark and No Bite?, in Emerging Issues In Philanthropy (The Urban Inst.), available at* www.urban.org/UploadedPDF/philanthropy_3.pdf.

2. Exceptions to the definition of unrelated trade or business. I.R.C. § 513(a).

3. Allocation of deductions from "dual use" assets. Treas. Reg. § 1.512(a)-1.

4. "Passive Income" modifications. I.R.C. § 512(b).

5. Controlled subsidiary rules. I.R.C. § 512(b)(13).

6. Debt-financed income. I.R.C. § 514.

7. Corporate sponsorship safe harbor. I.R.C. § 513(i).

8. Application of rules to the Internet.

II. Activities That Do Not Meet the Definition of Unrelated Trade or Business.

A. Three-Prong Definition. An activity is subject to UBIT only if it satisfies all three parts of the definition of an unrelated trade or business. Specifically, it must be--

1. A trade or business

2. Regularly carried on

3. That is not substantially related to the organization's exempt purpose.

I.R.C. § 512(a)(1); I.R.C. § 513(a). If an activity fails to satisfy any one of the three criteria above, it is not an unrelated trade or business and will not be subject to UBIT.

B. Trade or Business.

1. Section 162. Under the Treasury Regulations, the term "trade or business" has the same meaning that it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Treas. Reg. § 1.513-1(b).

2. Profit Motive. An activity will not be considered an unrelated trade or business unless the organization's primary motive is to earn a profit. *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990).

3. Using Losses. An organization that engages in an unrelated activity that consistently results in losses may not be able to offset UBTI from other activities with those losses; the activity generating losses may not be a trade or business because the organization lacks a profit motive. *See id.* (social club's non-member sales not conducted with the requisite profit motive to constitute a trade or business and taxpayer was not permitted to use its losses from non-member food and beverage sales to reduce its UBTI from investment income).

4. **Fragmentation Rule.** In determining whether an activity is an unrelated trade or business, an activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities that may or may not be "related" activities. Therefore, UBTI can arise even where an overall activity bears an overall relationship to an organization's exempt purposes. I.R.C. § 513(c).

   (a) For example, the sale of advertising in an exempt organization's publications will be treated as a separate activity for purposes of the UBIT analysis. *See* Treas. Reg. § 1.513-1(b).

   (b) Similarly, in the context of merchandising, an item-by-item analysis must be conducted to determine whether sales give rise to UBTI. *See* Rev. Rul. 73-105, 1973-1 C.B. 264.

C. Regularly Carried On.

1. **General Rule.** The Treasury regulations provide that, in determining whether a trade or business is regularly carried on, "regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued." Treas. Reg. § 1.513-1(c)(1).

2. **Commercial counterpart/benchmark.** Business activities "will ordinarily be deemed *regularly carried on* if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations." *Id.*

   (a) However, if the activities are of a type that a nonexempt business carries on year round, the conduct of such activities by an exempt organization over a period of only a few weeks should not cause the activities to be deemed "regularly carried on." *See* Treas. Reg. § 513-1(c)(2)(i).

   (b) Thus, for example, the operation of a sandwich stand by a hospital auxiliary for only two weeks at a state fair does not constitute the regular conduct of a trade or business. *See id.*

   (c) However, the operation of a commercial parking lot on Saturday of each week year round would constitute the regular operation of a business. *See id.*

3. **Seasonal Activities.** Where a non-exempt commercial organization would typically conduct a business of a particular type only on a seasonal basis, the conduct of a similar activity by an exempt organization during a

"significant portion" of the season ordinarily constitutes the regular conduct of a trade or business. *See id*.

4. Intermittent Activities.

(a) According to the regulations, "exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive or promotional efforts typical of commercial endeavors." Treas. Reg. § 1.513-1(c)(2)(ii).

(b) Income producing or fund raising activities that last only a short period of time are not regularly carried on if they occur "only occasionally or sporadically." Treas. Reg. § 1.513-1(c)(2)(iii). The fact that such activities occur on an annually recurring basis should not change this result. *Id*.

(c) *National Collegiate Athletic Ass'n v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990).

(i) In the *NCAA* case, the Tenth Circuit Court of Appeals considered whether income from advertising in the Final Four Tournament program was taxable as UBTI. The program, which was prepared by a commercial publisher, was produced over the course of several months, although the programs were sold only over a period of weeks at an event that occurred only once a year. Considering only the period over which the program was sold, the court held that the revenues were not derived from an activity that is regularly carried on.

(ii) The IRS refused to acquiesce in the *NCAA* decision and has stated that it will not follow the decision outside the Tenth Circuit. Indeed, since the *NCAA* decision, the IRS has issued rulings that adopt a more aggressive posture in concluding that similar activities were regularly carried on. *See, e.g.*, PLR 9137002 (Apr. 29, 1991); PLR 9721001 (Oct. 17, 1996).

(d) *Suffolk County Patrolmen's Benevolent Ass'n v. Commissioner*, 77 T.C. 1314 (1981), *acq.*, 1984-2 C.B. 2.

(i) In the *Suffolk County* case, the taxpayer had entered into contracts with a professional fundraiser to produce four performances of a vaudeville show each year on a weekend and to sell advertising in a program guide to be distributed in connection with the shows. The solicitation of advertising and sale of show tickets spanned a period of approximately 16 weeks each year. Based on these facts, the Tax Court concluded that the activities were intermittent activities that were not regularly carried on.

(ii) Unlike the *NCAA* case, the IRS has acquiesced in the *Suffolk County* case, stating: "The issue is factual and it cannot be said the Court's findings and conclusions were clearly erroneous." *See* A.O.D./C.C.-1984-020 (Mar. 22, 1984). Though hardly a resounding endorsement of the court's conclusions, this Action on Decision at least represents a tacit acknowledgment that certain recurring activities that occur over the course of several weeks a year may not be treated as "regularly carried on" for purposes of determining whether the activity is an unrelated trade or business.

(e) In light of the loosely defined and varying standards that may apply in different jurisdictions and the Service's obvious antipathy toward the *NCAA* decision, the regularly carried on prong of the definition can be an uncertain planning tool.

D. Not Substantially Related.

1. General Rule.

(a) Whether an activity is substantially related to an organization's exempt purposes is a fact-based inquiry that necessitates an examination of the relationship between the activity and the accomplishment of a particular organization's exempt purposes. *See* Treas. Reg. § 1.513-1(d)(1). The inquiry does *not* look to whether the activities compete with similar activities of non-exempt organizations.

(b) To be "related," the activities must have a "causal" relationship to the achievement of the organization's exempt purposes (other than through the production of funds). *See* Treas. Reg. § 1.513-1(d)(1)-(2). To be "substantially" related, the production of goods or performance of services from which the income is derived must "contribute importantly" to the accomplishment of the organization's exempt purposes, giving consideration of the size and extent of the activities involved. *See id*; Treas. Reg. § 1.513-1(d)(3).

2. Considerations of scale. However, if activities that otherwise contribute importantly to the accomplishment of the organization's exempt purposes are conducted on a larger scale than is reasonably necessary for the performance of such functions, the portion of the income attributable to the excess will be considered income from an unrelated activity. *See* Treas. Reg. § 1.513-1(d)(3).

3. **Nature of organization/stated exempt purposes.** To be "substantially related," the activity must be related to the stated exempt purposes of the *particular exempt organization involved*. Therefore, even if an activity may serve a legitimate section 501(c)(3) charitable, educational or other purpose, if such purpose is not a stated purpose of the relevant organization, the activity will not be considered substantially related, and income from the activity may give rise to UBTI. *See* Rev. Rul. 73-105, 1973-1 C.B. 264 (sale of science books by an art museum is unrelated).

4. **Museums.**

(a) Most of the guidance involving exempt organizations' sale of merchandize has arisen in the context of museum shops. In determining whether a particular item is related, the Service has framed the issue as whether the primary purpose for selling the item is to further the organization's exempt purpose or to generate income.

(b) Items that generally may be related to an exempt organization's purpose include reproduction of items in a museum's collection; adaptations of items in a museum's collection if there is literature explaining the relationship of the item to the original; books, tapes, records and films on the subject of the organization's exempt mission; children's educational toys and games; and, utilitarian products that have accurate depictions of wildlife, flora or fauna, or artwork.

(c) Items that generally are not related include those that are utilitarian in nature such as clothing and household items unless they are replicas of period pieces or adaptations of items in a collection with accompanying literature (e.g., scarves, neckties); contemporary items at prices equal to those charged by commercial entities (e.g., contemporary watches sold by a museum with a timekeeping collection); souvenirs, inexpensive mementos, and logo items such as coffee mugs, t-shirts, and tote bags.

See generally TAM 8326003 (Nov. 17, 1982), *modified*, TAM 9720002 (Nov. 26, 1996); TAM 9550003 (Sept. 8, 1995); Rev. Rul. 73-104, 1973-1 C.B. 263.

5. Travel Tours.

(a) The conduct of travel tour activities by exempt organizations has been of particular interest to the Service for the past several years and is a challenging area for tax planners. After much study, the Service issued final regulations concerning travel tours effective February 7, 2000. *See generally* Treas. Reg. § 1.513-7.

(b) Unfortunately, the final regulations did not enumerate any specific factors that determine relatedness of travel tour activities to exempt purposes.[3] Instead, the regulations adopt a general facts and circumstances approach and provide several examples.

(c) Among the relevant facts and circumstances to be considered are how the travel tour is developed, promoted and operated. Although there is no substantiation requirement built into the rules, the examples suggest that contemporaneous documentation concerning these circumstances is important to the analysis. *See* 2002 CPE Text at 196.

(d) The regulations explicitly provide that the fragmentation rule applies to travel tours. *See* Treas. Reg. § 1.513-7(b). Therefore, an exempt organization may operate some tours that are related and others that are not.

(e) In its 2002 CPE Text (at p. 196), the IRS provided several examples of related and unrelated travel tours:

(i) Environmental research trips conducted by a Section 501(c)(3) organization are substantially related to its exempt scientific purposes where tour participants assist biologists in collecting data for a scientific study and share rustic base accommodations with few amenities.

(ii) Travel tours conducted by a Section 501(c)(3) organization devoted to the study of ancient history and cultures are substantially related to its exempt educational purpose where tours of archaeological sites led by experts are part

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[3] *See* Internal Revenue Service, *UBIT: Current Developments, Exempt Organizations Continuing Professional Education Text for Fiscal Year 2002*, § F, at 195 ("*2002 CPE Text*"). The CPE Texts for the last several years are available on the Service's website at *www.irs.gov*. Under contents on the left hand side, choose Charities and Nonprofits and then search the cite for "CPE." These texts are used by the Service for internal training purposes and have no precedential value.

of a coordinated educational program designed to educate tour participants.

(iii) Travel tours conducted by a Section 501(c)(3) organization devoted to the study of the performing arts are not substantially related to its exempt educational purpose where the tour program is primarily social and recreational in nature, and the scheduled activities, which include sightseeing and attendance at various cultural events, are not part of a coordinated educational program.

III. Full Utilization of Deductions.

A. In General. Section 512(a) defines UBTI to mean "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, *less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business,* both computed with the modifications provided in subsection (b)." (Emphasis added). To be deductible in computing UBTI, therefore, expenses, depreciation and similar items not only must qualify as deductions under Chapter 1 of the Code, but also must be "directly connected with" the operation of the trade or business. *See* Treas. Reg. § 1.512(a)-1(a). To be directly connected, the item of deduction must "have proximate and primary relationship to" the carrying on of the business. *See id*.

B. Dual-use Property/Allocations.

1. Where an item of deduction is attributable solely to unrelated business activities, the item of deduction is proximately and primarily related to that business. *See* Treas. Reg. § 1.512(a)-1(b).

2. However, where facilities and personnel are used both for an exempt purpose and in connection with an unrelated trade or business (i.e., dual use), the expense, depreciation or similar item must be allocated between the activities "on a reasonable basis." *See* Treas. Reg. § 1.512(a)-1(c).

3. Organizations that operate unrelated trades or businesses (or which have activities reclassified by the Service as unrelated activities) obviously have an incentive to allocate as many deductible items as possible to the unrelated activities in order to minimize or eliminate the taxable net profit arising from those activities.

4. What is Reasonable? In a case involving the various student (i.e., related) and commercial (i.e., unrelated) uses of the field house owned by Rensselaer Polytechnic Institute, the Internal Revenue Service ("Service") argued that the school should allocate fixed expenses to commercial uses based on the proportion the commercial use bore to the total time the field house was available for use. The school, on the other hand, argued that the allocation should be made based on the proportion the commercial use bore to the total amount of time the field house was actually in use (which results in a larger percentage of the fixed costs being allocated to the commercial, unrelated use). The court held that the college's methodology was reasonable. *See Rensselaer Polytechnic Inst. v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984). The Service did not acquiesce in the decision, but did not appeal the decision to the Supreme Court.

C. **Exploitation of Exempt Activities.** Special rules apply where an unrelated trade or business activity exploits an exempt activity. Although not limited by the regulations, this rule seems to apply primarily to the sale of advertising in a periodical containing editorial material related to the accomplishment of the organization's exempt purpose. *See* Treas. Reg. § 1.512(a)-1(d).

1. In most such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities will not be deductible in computing UBTI, because they are incident to a related activity. *See* Treas. Reg. § 1.512(a)-1(d)(1).

2. However, where the unrelated activity is of a kind ordinarily conducted by a taxable organization and the exempt activity is of a type normally conducted by taxable organizations in pursuit of such businesses, expenses and other items attributable to the exempt activity may be deductible in connection with the unrelated activity under certain circumstances. *See* Treas. Reg. § 1.512(a)-1(d)(2). This will be the case only to the extent that the amount of such items exceeds the amount of income derived from the exempt activity, and the allocation of such items to the unrelated activity does not result in a loss from that activity. *See id.*

IV. Statutory Exceptions to Defintion of Unrelated Trade or Business.

A. **Volunteers.** Section 513(a)(1) excludes from the definition of "unrelated trade or business" activities in which substantially all of the work in carrying out the trade or business is performed without compensation, *i.e.*, by volunteers.

B. **Convenience Exception.** Also excluded are activities carried on by a Section 501(c)(3) organization (or college or university described in section 511(a)(2)(B)) "primarily for the convenience of its members, students, patients, officers, or employees." *See* I.R.C. § 513(a)(2); Treas. Reg. § 1.513-1(e)(2). For example, a laundry operated by a college for the purposes of laundering dormitory linens and the clothing of students would be considered an activity conducted for the convenience of the colleges students, and thus would not constitute an unrelated trade or business. *See* Treas. Reg. § 1.513-1(e) (flush language).

C. **"Thrift Shop" Exception.** Also excluded by statute from the definition of unrelated trade or business is the "selling of merchandise, substantially all of which has been received by the organization as gifts or contributions." I.R.C. § 513(a)(3). The regulations explain that this "exception applies to so-called 'thrift shops' operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization." Treas. Reg. § 1.513-1(e) (flush language).

D. **Other Statutory Exceptions.** The Code also provides for several other statutory exceptions from the definition of "unrelated trade or business," including:

1. Certain qualified public entertainment activities (*see* I.R.C. § 513(d)(2));

2. Certain qualified convention and trade show activities (*see* I.R.C. § 513(d)(3));

3. Certain cooperative hospital services (*see* I.R.C. § 513(e));

4. Certain bingo games (*see* I.R.C. § 513(f));

5. Certain pole rentals by mutual or cooperative telephone or electric companies (*see* I.R.C. § 513(g));

6. Distribution of low-cost articles incidental to the solicitation of charitable contributions (*see* I.R.C. § 513(h));

7. Certain rentals and exchanges of mailing lists among certain exempt organizations (*see id*.); and

8. Qualified corporate sponsorship payments (*see* I.R.C. § 513(i)). The rules relating to corporate sponsorship payments are discussed in greater detail below.

V. "Passive Income" Modifications to UBTI.

A. **Overview.** Since the enactment of the UBIT in 1950, the Code has excluded several types of income such as interest, dividends, annuities and royalties from the definition of UBTI. *See* I.R.C. § 512(b). These UBTI "modifications," which generally involve so-called "passive" income, present a number of tax-planning opportunities. Royalties, rents and income from research activities are each discussed in this section. However, "passive income" excluded under Section 512(b) may nevertheless be taxable if it is derived from debt-financed property, *see* section 514, or paid by a controlled subsidiary, *see* section 512(b)(13). See below for a discussion of debt-financed property and taxation of income from controlled subsidiaries.

B. Royalties: Avoiding UBIT by Structuring Business Transactions as Licensing Agreements.

1. **In General.** Licensing often offers an exempt organization the ideal situation -- good business planning and good tax planning. There are many situations where licensing is the best way for an exempt organization to engage in a business activity. Some typical examples include:

   (a) An exempt organization licensing the right to use its trademark on products that the organization does not have the expertise to produce and market itself. *E.g.*, clothing, toys, coffee mugs, etc.

   (b) An exempt organization that holds a patent that has commercial potential but requires further development may license the right to develop the idea protected by the patent to a third party in order to exploit it commercially.

   (c) Many exempt organizations license the right to their mailing lists to earn revenues that can be used to further the organization's exempt purpose.

2. **Definition of Royalty for Tax Purposes.** The term "royalty" is not defined in the Code or the Treasury regulations. In the leading IRS ruling on the definition of royalty, Revenue Ruling 81-178, 1981-2 C.B. 135, the Service defined a royalty as a payment for the use of a valuable right, generally including payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, and payments for the use of an individual's name, photograph, likeness, or facsimile. The Service distinguished payments for personal services from payments for the use of intangible property.

3. **How to Structure Licensing Agreements to Produce Tax-Free Royalty Income.**

   (a) **Transactions that do not involve provision of services by the licensor.** In situations where the exempt organization licenses its intellectual property to a third party and is not involved in any activity that could be construed as providing a service, the income should be treated as royalty and excluded from UBIT. It is important, however, to be sure that the agreement is drafted as a royalty agreement and it may be necessary to retain a lawyer to ensure that the agreement is properly drafted.

   (b) **Transactions where licensor wants to provide services.** Where it is important or necessary for the licensor to provide services, careful tax planning is important to maximize royalty treatment for income received. In numerous cases involving affinity credit cards and the licensing of mailing lists, the Service took the position that the provision of services in connection with the licensing of intellectual property taints the entire payment. The courts rejected this position, *see, e.g., Sierra Club v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), and the Service has indicated that it has the issue of allocation under consideration in the National Office, but no guidance has been issued. Memorandum from IRS National Office to EO Area Managers (Dec. 16, 1999).

(i) **Using a for-profit subsidiary**. One tax planning technique to protect the royalty character of income received for use of intellectual property is the use of a wholly-owned for-profit subsidiary to provide services to the licensee. In this situation, the exempt organization parent can license its intellectual property, such as trademarks and mailing lists, to a third party pursuant to a licensing agreement and receive income that will be treated as a royalty for tax purposes. A wholly-owned for-profit subsidiary can provide services to the licensee pursuant to a separate agreement and receive income for services which is taxable. The services might include, for example,

- Receiving, reviewing, and recommending modifications to strategic and operating plans of the service providers;
- Auditing and inspecting management reports, complaints, finances, and statistical data of the service providers;
- Approving the nature and timing of communications of the service providers with X's members;
- Monitoring performance of the service providers and helping resolve claims, disputes, and other problems with the service providers;
- Creating marketing services respecting X's membership list; and
- All other activities as are necessary to promote the service providers.

Assuming that the for-profit subsidiary is separately incorporated and separately run, its activities will not be attributed to its parent and the provision of services will not affect the character of the income received by the parent for the use of its trademarks and mailing lists or other intellectual property. *See* PLR 199938041 (June 28, 1999), *modified*, PLR 200149043 (Aug. 1, 2001). *See also* PLR 200303062 (Oct. 22, 2002).

(ii) **Separate contracts.** If setting up a separate subsidiary is not feasible or desirable, the organization should consider entering into separate contracts for licensing of intellectual property and provision of services. Both agreements should require a payment that reflects fair market value.

(iii) **Allocation of income received.** If separate contracts are not feasible, the organization should maintain careful records of the time and resources spent on providing services to commercial entities in connection with licensing the organization's intangibles to such entities. The portion of the payment received by the organization under a license that is commensurate with the value of the services provided by the organization to the program should be allocated to compensation for services and treated as UBTI on the organization's annual information return. In *Oregon State University Alumni Ass,n, Inc. v. Commissioner*, 193 F.3d 1098 (9th Cir. 1999), *aff'g* 71 T.C.M. (CCH) 1935 (1996) and 71 T.C.M. (CCH) 1093 (1996), the court indicated that allocation may be a reasonable solution to deciding the issue of royalty vs. services in the context of licensing agreements between tax-exempt organizations and for-profit businesses.

4. **Common Licensing Transactions.** There has been a great deal of litigation involving the exclusion of income from UBTI under the royalty exclusion. The decided cases provide tax practitioners with substantial guidance in structuring such transactions.

(a) **Affinity Credit Cart Programs.**

(i) In the typical affinity credit card arrangement, an exempt organization licenses to a bank the right to use the exempt organization's name, logo, or trademark on credit cards issued by the bank and on marketing materials promoting the card. The organization also licenses its member list or other mailing list to the bank so that the bank can promote its credit card to the organization's members, donors, alumni or other affiliated persons. The bank typically pays the exempt organization a fee for each card issued and a percentage of purchases made using the credit card.

(ii) The tax treatment of these arrangements has been the subject of extended litigation. *See, e.g., Oregon State Univ. Alum. Ass'n v. Commissioner*, 193 F.3d 1098 (9th Cir. 1999); *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), *aff'g in part, rev'g in part and remanding*, 103 T.C. 307 (1994) *and* 65 T.C.M. (CCH) 2582 (1993). Exempt organizations took the position that payments from the bank were royalties, while the Service claimed that the exempt organizations provided services to the bank and that the provision of services caused the payments to fail to qualify as royalties for purposes of Section 512(b)(2). In a series of cases, the courts found that services provided by the exempt organizations were either de minimis and, therefore, did not affect the categorization of the payments received as payments for the use of the organization's intellectual property or that activities that the Service viewed as services to the bank were in fact permissible activities undertaken by the exempt organization to protect the value of its intellectual property. In Memorandum from the IRS National Office to EO Area Managers (Dec. 16, 1999), the Service announced that it will not pursue cases presenting similar facts in the future.

(iii) **Guidelines**. From the affinity card cases, it is clear that a tax-exempt licensor of intellectual property can take actions to safeguard the value of its intellectual property such as reviewing promotional materials for the card that include the use of the organization's name and mark. An organization also can advertise the card in its publications if it charges the bank issuing the card the same rate that it would charge any other party for a similar ad. It is advisable to have arrangements for advertising in a separate agreement. Based on the court's approach to advertising, it seems logical that an exempt organization could also provide other products or services so long as it charged an arms length rate. For example, the organization might sell products to the bank which the bank would then offer as premiums to members who signed up for a card. However, while there is logic to this argument, there is also a tendency for the courts to look at the overall level of activity on the part of the exempt organization and, accordingly, exempt organizations should proceed cautiously when going beyond the facts of the decided cases.

From the affinity card cases, organizations also can conclude that they should not directly promote or market the card to their members but, rather, should leave that to the bank. While promotion in a de minimis fashion is not fatal, organizations should be careful to limit such promotion.[4] In the event the organization does engage in promotion, it should obtain reimbursement from the bank for any out of pocket costs. Similarly, the tax-exempt organization should not control marketing plans but should merely approve materials to ensure that the organization's name and mark is properly presented and the materials are not in any way damaging to, or inconsistent with, the organization's reputation and goodwill. The organization also should not endorse the card beyond the endorsement that is implicit in the license of the organization's mark.

(b) **Mailing Lists**. The issue whether income from the sale or rental of an exempt organization's mailing list, beyond exchanges or rentals of members lists among certain exempt organization, as described in section 513(h), constitutes a royalty or is taxable as UBTI has also been the subject of much litigation. As a general matter, income from mailing list rentals will be considered a nontaxable royalty so long as the organization does not perform services in connection with the arrangement. To be considered royalty-related, the activities of the exempt organization must be for the purpose of exploiting or protecting the organization's intellectual property, not for the benefit of the renter or purchaser. *See, e.g.*, *Common Cause v. Commissioner*, 112 T.C. 332 (1999); *Planned Parenthood Fed'n of Am., Inc. v. Commissioner*, T.C. Memo 1999-206 77 T.C.M. (CCH) 2227 (1999).

The mailing list cases differ from the affinity card cases in one significant respect. Affinity card agreements are usually exclusive and thus, while an exempt organization may occasionally enter into a new agreement or renew an existing agreement, the organization is not entering into affinity card agreements on an ongoing basis. By contrast, an organization that views its mailing list as a valuable asset and has made a decision to exploit that asset to raise revenue wants to enter into numerous nonexclusive agreements to rent its

[4] It appears that it would be permissible for an organization to indicate on its website that it has an affinity credit card agreement with a bank and provide contact information including a link to the bank's website. *See* PLR 200303062 (Oct. 22, 2002).

list to third parties. Moreover, the ongoing commercial exploitation of mailing lists requires marketing and database management. Because of the substantial industry that supports the mailing list rental business, exempt organizations have been able to structure their mailing list rental activities so that the organization does not provide more than de minimis services to the lessee of the lists and, thereby, have obtained royalty treatment for amounts paid for use of the list.

(c) **Publishing.** In contrast to the affinity card and list rental cases, exempt organizations have not been successful in structuring agreements for the publication of magazines as licensing agreements that give rise to royalty income. In these cases, the publications were closely associated with the exempt organizations and the organizations exercised far more day-to-day control than in the affinity card and mailing list cases. The Service has generally been successful in attributing the publisher's activities to the tax-exempt organization under the agency rationale and in using this attribution to characterize the resulting income as compensation for services rather than royalties. *State Police Ass'n of Massachusetts v. Commissioner*, 125 F.3d 1 (1st Cir. 1997), *cert. denied*, 522 U.S. 1108 (1998). In addition, at least one court has held that income from licensing the organization's intangibles to a service provider in connection with publishing the organization's own publication will be treated as UBTI regardless of whether the organization provides any services in connection therewith because the publication is used to promote the organization itself rather than the licensee's product. *Arkansas State Police Ass'n, Inc. v. Commissioner*, 282 F.3d 556 (8th Cir. 2002), *aff'g*, 81 T.C.M. (CCH) 1172 (2001).

C. Rents.

1. **In General.** The exclusion of rents from real property from UBTI offers exempt organizations an opportunity to earn tax-free income from rental of real property owned by the organization and used in its operations as well as from investments in real property (assuming the debt-financed income rules do not apply).

2. **Statutory Rules.**

(a) **Generally.** As a general matter, rents from *real property* are excluded in computing UBTI. *See* I.R.C. § 512(b)(3).

(b) **Mixed Leases.** Special rules apply to "mixed leases" involving both real and personal property.

(i) If rents attributable to personal property are less than 10% of the total rents (determined at the time the personal property is placed in service), all of the rents are generally excluded from UBTI. *See* I.R.C. § 512(b)(3)(A)(ii).

(ii) If rents attributable to personal property are more than 10% but not more than 50% of the total rents, only rents attributable to real property are excluded. *See* I.R.C. § 512(b)(3)(i).

(iii) If rents attributable to personal property are more than 50% of the total rents, none of the rents are excludable. *See* I.R.C. § 512(b)(3)(B)(i).

(iv) If separate leases are entered for real and personal property but the properties have an integrated use, all leases will be considered a single lease for purposes of determining the amount attributable to personal property and real property, respectively.

(c) **Personal Services.** Income from the occupation of space, when personal services are also provided to the occupant (*e.g*., hotel rooms), does not constitute rent from real property. Treas. Reg. § 1.512(b)-1(c)(5). Generally, services are considered rendered to the occupant if they are for his or her convenience and are not those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. Many exempt organizations lease space during times that the organization is not using it. This can be an excellent source of revenue, but exempt organizations must be careful not to provide services that will cause the rental income to be taxable. Several examples follow.

(i) In Rev. Rul. 80-298, 1980-2 C.B.197, an exempt university leased its stadium to a professional football team for several months each year and furnished the utilities, playing field maintenance, dressing room, linen, and stadium security services. The Service ruled that the income from the lease was not excluded from UBTI because the playing field maintenance, dressing room, linen and security services were substantial services that went beyond those customarily rendered in connection with the rental of space for occupancy only.

(ii) In contrast, arranging for parking and maintaining the grounds surrounding a building is not an impermissible service. *Madden v. Commissioner,* 74 T.C.M. (CCH) 440 (1997). In *Madden*, a museum leased an outdoor theater to a performing arts organization and contracted with a landscaping company to maintain the grounds surrounding the theater. Under the lease agreement, the museum was obligated to arrange for 5,000 parking spaces. To fulfill this obligation, the museum entered into parking license agreements with owners of nearby buildings. The court held that the provision of maintenance services and the parking arrangements were not impermissible services for purposes of Treas. Reg. § 1.512(b)-1(c)(5). The court, however, held that the rent received by Museum from leasing the theater was subject to UBIT because the amount of the rent was based, in part, on net profits. (See discussion below on contingent rents.)

(iii) In TAM 9702003 (Aug. 28, 1996), an organization rented its facilities to third parties for special events. The organization provided personnel to set up and operate equipment and purchased liquor (because it held the liquor license). The third party arranged for catering. The Service held that the income received did not qualify for the exclusion for rents because of the provision of services.

(d) **Rent Contingent on Income or Profits.** The exclusion for rents does not apply if the amount of rent depends on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage of sales. *See* I.R.C. § 512(b)(3)(B)(ii).

(i) In *Independent Order of Odd Fellows Grand Lodge of Iowa v. U.S.*, 93-2 USTC ¶50,448 (S.D. Iowa 1993), a tax-exempt fraternal order, described in section 501(c)(8), owned six parcels of farm real estate. The land was farmed pursuant to crop share lease agreements. Under the lease agreements, the order received 50% of the crops produced and paid 50% of some of the costs incurred in their production. The lodge and each tenant sold and marketed their respective shares of the crops at different times and for different prices. The Commissioner argued that the rents received by the order from these lease agreements were subject to UBIT because they were based on the income or profits from the leased property within the meaning of Section 512(b)(3)(B)(ii). The order argued that the rents were not subject to UBIT because they were based on a percentage of receipts or sales within the parenthetical exception to the same Code Section. The court held that the pre-expense division of crops under the lease agreements was more analogous to sales or receipts than to net income or profits. Thus, the income from the order's share of crops was held to be excludable from UBIT.

(ii) In contrast, in *State National Bank of El Paso v. U.S.*, 509 F.2d 832 (5th Cir. 1975), the court held that the rental income received by the organization was not excludable from UBTI because the organization as lessor bore all risk of loss, approved and financed all operating expenses, and received rental income based on the profits of the business.

D. Research Income.

1. The Exclusions. In computing UBTI, income from certain research activities is excluded.

(a) Section 512(b)(7). All income derived from research for (i) the United States or any of its agencies or instrumentalities, or (ii) any State or political subdivision thereof is excluded from UBTI.

(b) Section 512(b)(8). In the case of colleges, universities and hospitals, all income from research performed for any person is excluded.

(c) Section 512(b)(9). An exclusion is provided for income derived from research performed for any person by an organization operated primarily for purposes of carrying on fundamental research, the results of which are freely available to the general public. To qualify for this exclusion, the organization conducting the research must first qualify as an organization that is engaged primarily in fundamental research and makes its results freely available. If the organization so qualifies, then any income earned from research conducted by it will be excluded from UBTI, even if the particular research from which income is earned is not fundamental research and is not made freely available to the public. Of course, such research must be limited or the organization will lose its status as a fundamental research organization, which is a prerequisite for qualifying for the exclusion under Section 512(b)(9) in the first instance.

2. Availability of Research Results. None of these exclusions requires that the results of the research be made publicly available, except that the exclusion under Section 512(b)(9) is limited to organizations that engage *primarily* in fundamental research that is made freely available to the public.

3. **What Is "Research"?** A critical issue in qualifying for these exclusions is whether the income-producing activity constitutes research. The regulations do not define research but do provide that research

> …does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term "fundamental research" does not include research carried on for the primary purpose of commercial or industrial application.

Treas. Reg. Section 1.512(b)-1(f)(4).

E. **Other Modifications.** Section 512(b) includes a number of other exclusions ("modifications") from the definition of UBTI that may or may not apply, depending on an organization's particular circumstances, including:

1. Dividends (but not income from S corporations);
2. Interest;
3. Annuities;
4. Payments with respect to securities loans and notional principal contracts; and
5. Capital gains.

VI. Taxation of Income from Controlled Organizations.

A. Pre- Tax Reform Act of 1997 ("TRA '97") .

1. As part of the Tax Reform Act of 1969, Congress enacted section 512(b)(13), which taxed exempt organizations on interest, rents, royalties and annuities received from subsidiaries in which they owned at least 80% of the combined voting power of all voting stock and at least 80% of the total number of shares of all other classes of stock.

2. This provision was intended to prevent exempt organizations from avoiding tax by having their controlled subsidiaries pay inflated amounts of passive income to the parent. Such amounts were deducted by the subsidiary, leaving the subsidiary with little or no taxable income, and were tax-exempt to the parent, thus enabling the parent to operate an unrelated business without incurring any substantial tax liability.

3. Section 512(b)(13) has never applied to dividends because dividends are not deductible by the corporation that pays them.

4. The 80% control test of the 1969 rules was easily avoided by either using a second tier subsidiary or having a third party own 21% of the stock. Because Section 512(b)(13) did not contain attribution rules, a second tier subsidiary was not considered to be controlled by the parent and a 21% stake could be owned by a friendly third party. *See, e.g.*, PLR 9016072 (Jan. 24, 1990); PLR 9324026 (Mar. 22, 1993); PLR 9338003 (June 16, 1993); PLR 9542045 (July 28, 1995).

B. Post-TRA '97.

1. TRA '97 amended section 512(b)(13) in several significant respects.

(a) The definition of "control" was lowered from 80% to greater than 50%. I.R.C. § 512(b)(13)(D).

(b) The attribution rules of section 318 are applied in determining control so that the ownership interests of related parties are aggregated for this purpose, thus eliminating the planning techniques described above. I.R.C. § 512(b)(13)(D)(ii).

(c) The computation rules were changed. Prior to TRA '97, the rules taxed a pro rata amount of "passive income" received from the subsidiary that reflected the portion of the subsidiary's income that would have been UBTI if the subsidiary were a tax-exempt organization with its parent's exempt purposes. If the subsidiary was operating at a loss, the "passive income" received by the parent would be tax-exempt. Under the '97 amendments, the parent is required to include as an item of gross income interest, rents, royalties and annuities received *or accrued from a controlled entity to the extent such payment reduces the net unrelated income of the controlled entity* or increases any net unrelated loss of the controlled entity.

(d) The Treasury was given authority to prescribe such rules as may be necessary or appropriate to prevent avoidance of the section 512(b)(13) through the use of related persons.

2. Computation of Income From Controlled Subsidiary that is Taxable to Controlling Parent.

(a) The first step is to determine the net unrelated income or loss of the controlled entity. "Net unrelated income" is the portion of the controlled entity's taxable income that would be UBTI if the controlled entity were exempt from tax and had the same exempt purpose as the controlling parent. I.R.C. § 512(b)(13)(B)(i). "Net unrelated loss" is the net operating loss "adjusted under rules similar to" those used to determine new unrelated income.

(b) The second step is to identify any interest, annuity, royalty or rent that has been received *or accrued* by the controlling parent *directly or indirectly* from the controlled entity.

(i) The accrual rule apparently applies even if the parent does not use the accrual method of accounting.

(ii) It is not clear when a payment is received indirectly by the parent.

(c) The third step is to include in the controlling parent's gross income any interest, annuity, royalty or rent identified in the second step that reduces the subsidiary's net unrelated income. It is not clear whether this is to be determined by tracing or on a pro rata basis.

3. Planning Techniques under Section 512(b)(13).

(a) **Transactions with third parties.** Some taxable income can be avoided by having the controlled subsidiary enter into transactions with unrelated third parties instead of with its controlling parent. For example, a controlled subsidiary that previously rented office space from its controlling parent can rent office space from a third party and its parent can rent the space previously occupied by the subsidiary to a third party. Similarly, a controlled subsidiary that previously borrowed funds from its parent can borrow from a third party and the parent can invest the funds previously loaned to the subsidiary in securities and receive tax-free interest or dividends.

(b) **Use of passive income exclusions.** Just as exempt organizations seek to structure transactions to take advantage of the exceptions for interest, rents, annuities and royalties, controlled subsidiaries should do the same, as such amounts will not be included in the definition of "net unrelated income."

C. Pending Legislation

1. Exempt organizations have objected to the '97 amendments on the grounds that section 512(b)(13) is overly broad in that it penalizes an exempt organization that enters into a legitimate arms length transaction with a subsidiary even though such a transaction is not abusive. In addition, that same transaction would not be penalized (or rearranged under section 482) if it were between the exempt organization and an unrelated third party.

2. As of this writing, the House and Senate have passed different versions of the CARE Act (H.R. 7; S. 476) but have not gone to Conference. Both versions contain provisions that would apply Section 512(b)(13) only to the extent that the payment received by a controlling organization is in excess of fair market value, but have different effective dates. If the amendments to section 512(b)(13) contained in the CARE Act become law, then exempt organizations will be able to reduce UBIT in some situations by conducting unrelated businesses in a subsidiary.

VII. Avoiding Debt-Financed Income.

A. Overview of Taxation of Debt-financed Income.

1. **Amount Included in UBTI.** Section 514(a)(1) requires an exempt organization to include in UBTI a percentage of income derived from "debt-financed property" equal to the "average acquisition indebtedness" for the taxable year over the average amount of the adjusted basis for the taxable year. A like percentage of deductions is allowed in computing UBTI. I.R.C. § 514(a)(2). All deductions allowable in computing taxable income are permitted in computing debt-financed income, except that only the straight-line method of depreciation is permitted. I.R.C. § 514(c)(3).

2. **Meaning of "Debt-financed Property."** Any property held to produce income with respect to which there is an acquisition indebtedness at any time during the taxable year or, if the property is disposed of during the taxable year, at any time during the 12-month period ending with the disposition. I.R.C. § 514(b)(1).

3. **Meaning of "Acquisition Indebtedness."** The unpaid amount of indebtedness incurred: (i) by the organization in acquiring or improving debt-financed property; (ii) before the acquisition or improvement of the debt-financed property if such indebtedness would not have been incurred but for such acquisition or improvement; and (iii) after the acquisition or improvement of the debt-financed property if (1) that indebtedness would not have been incurred but for such acquisition or improvement and (2) incurring such indebtedness was reasonably foreseeable at the time of the acquisition or improvement. I.R.C. § 514(c).

B. Statutory Exceptions and Exclusions.

Statutory Exceptions and Exclusions. The primary target of the debt-financed income rules is investment income rather than income from an exempt organization's conduct of its exempt functions. Accordingly, the Code contains a number of exceptions for property that is used by or acquired by an organization in the conduct of its exempt functions and for indebtedness that exempt organizations may commonly incur that is not inconsistent with their exempt purposes. While some of the exceptions are straightforward, others contain rules that can be the proverbial "trap for the unwary."

1. **Substantially Related Use.** As mentioned above, property is not treated as debt-financed if substantially all the use to which it is put is substantially related to the organization's exempt purpose. In general, an organization qualifies for this exception if 85% or more of the property is devoted to the organization's exempt purpose. Treas. Reg. § 1.514(b)-1(b)(1)(ii). The extent to which property is used for a particular purpose is determined by all the facts and circumstances. These may include a comparison of time that property is used for exempt purposes and other purposes, or a comparison of the portion of property that is used for exempt purposes and other purposes.

2. **Neighborhood Land Exception.** The neighborhood land exception is a special rule for exempt organizations that acquire nearby land for future use. Because the land is not immediately used for substantially related purposes, it would not qualify under that exception. Advisors of organizations acquiring land that they expect to qualify under this section should fully familiarize themselves with these rules to ensure compliance with those requirements. *See* I.R.C. § 514(b)(3); Treas. Reg. § 1.514(b)-1(d).

3. **Property Acquired by Bequest, Devise, or Gift.** Where property is acquired subject to a mortgage or other lien, the amount of indebtedness secured by the mortgage or lien is treated as acquisition indebtedness even if the organization did not assume or agree to pay for such indebtedness. I.R.C. § 514(c)(2)(A). However, in Revenue Ruling 76-95, 1976-1 C.B. 172, the Service held that an organization had no acquisition indebtedness when it acquired an undivided interest in rental property subject to a mortgage but prepaid its proportionate share of the mortgage indebtedness, and received releases of liability from the mortgagee and co-owners. If mortgaged property is acquired through a bequest or devise, the indebtedness is not treated as acquisition indebtedness for ten years. I.R.C. § 514(c)(2)(B). If it is acquired by gift, it is not treated as acquisition indebtedness for ten years if the property was held by the donor for more than five years prior to the date of the gift and the mortgage was placed on the property more than five years before the date of the gift. This ten-year exception does not apply if, in order to get the bequest, devise, or gift, the organization agreed to assume the indebtedness or the organization makes any payment for equity in the property. *See* PLR 9431001 (Feb. 1, 1994) (organization solicited donation of debt-financed property as part of fundraising drive and resold it).

4. **Others Exceptions and Exclusions.**

   (a) Any property to the extent income is excluded under section 512(b)(7) relating to government research; section 512(b)(8) relating to college, university, and hospital research; and section

512(b)(9) relating to fundamental research the results of which are made freely available to the public. I.R.C. § 514(b)(1)(C).

(b) Property used in any trade or business described in section 513(a)(1) relating to work performed by volunteers, section 513(a)(2) relating to convenience of members, etc., and section 513(a)(3) relating to selling of merchandise received as gifts. I.R.C. § 514(b)(1)(D).

(c) Mortgage indebtedness on property acquired by bequest or devise for ten years after the acquisition, if certain other conditions are met. I.R.C. § 514(c)(2)(B).

(d) Liens for taxes and assessments that attach before the payment date. I.R.C. § 514(c)(2)(C).

(e) Extensions, renewals, or refinancings of an obligation evidencing a pre-existing indebtedness. I.R.C. § 514(c)(3).

(f) Indebtedness inherent in performing an organization's exempt purpose, such as indebtedness incurred by a credit union accepting deposits from its members. I.R.C. § 514(c)(4).

(g) Charitable gift annuities. I.R.C. § 514(c)(5).

(h) Certain federal financing for low- and moderate-income persons. I.R.C. § 514(c)(6).

(i) Securities loans. I.R.C. § 514(c)(8).

(j) Real property acquired by pension trusts and schools, colleges, and universities. I.R.C. § 514(c)(9)(A).

C. Tax Planning to Avoid Debt-financed Income.[5]

1. "Leveraged" Transactions that Are Not "Debt Financed." Neither the Code nor the regulations contain a definition of indebtedness and, consequently, common law definitions apply.[6] As a result, many

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[5] For a more detailed discussion of the debt-financed property rules, *see* Suzanne Ross McDowell and Howard E. Abrams, *Applying the Unrelated Debt-Financed Income Rules to Investments in Real Property*, 15 Taxation of Exempts 3 (July/August 2003) and Suzanne Ross McDowell, *What You Need to Know About the Unrelated Debt-Financed Income Rules*, 14 Taxation of Exempts 206 (Mar./Apr. 2003).

[6] *See generally* Douglas M. Mancino & Frances R. Hill, *Taxation of Exempt Organizations* ¶ 26.03[1]. (Warren, Gorham & Lamont, 2002).

sophisticated investors are able to avoid the debt-financed property rules through investments that are leveraged but do not fall within a common law definition of indebtedness. By contrast, an organization that borrows in the traditional sense -- *i.e.*, receiving money with an obligation to repay it -- will be subject to UBIT under the debt-financed property rules. For example, buying stock on margin is treated as debt-financed. *Henry E. & Nancy Horton Bartels Trust for the Benefit of the Univ. of New Haven v. United* States, 209 F.3d 147 (2d Cir.), *cert. denied*, 531 U.S. 978 (2000). The transactions below are sophisticated investments that involve "leverage" in a broad sense but are not treated as debt-financed not subject to the debt-financed income rules.

(a) **Securities lending transactions.** Section 514(c)(8) provides that payments with respect to securities loans are deemed to be derived from the securities loaned, not from collateral security or the investment of collateral security from such loans. Similarly, any deductions that are directly connected with collateral security for a securities loan, or with the investment of collateral security, are deemed to be deductions that are directly connected with the securities loaned. Finally, an obligation to return collateral security is not treated as acquisition indebtedness.

(b) **Short sales of stock.** The Service has ruled that neither the gain attributable to the decline in the price of the stock sold short nor the income earned on the proceeds of the short sale held as collateral by the broker constituted debt-financed income. Rev. Rul. 95-8, 1995-1 C.B. 107.

(c) **Commodities futures transactions.** In G.C.M. 39620 (Apr. 3, 1987), the Service concluded that gains and losses from commodity futures contracts are excluded from UBTI under Code section 512(b)(5). The Service concluded that the obligation of a holder of a long position to pay for the commodity on delivery did not constitute indebtedness because it was an executory contract and neither the seller for the buyer actually held the property at the time of entering into the contract. The purchase of a long futures contract entailed no borrowing of money in the traditional sense. Similarly, the Service found a short contract was merely an executory contract because there was no property held by the short seller that produced income and thus there could be no acquisition indebtedness.

(d) **Securities arbitrage transactions.** The Service has also addressed complicated securities arbitrage transactions that take advantage of the differential between the value of a stock index futures contract and the value of stocks comprising the index. *See* G.C.M. 39615 (Mar. 23, 1987).

(e) **Notional principal contracts.** The Service has issued regulations providing that all income and gain from notional principal contracts is excluded from UBTI. *See* Treas. Reg. § 1.512(b)-1(a)(1).

2. Blocker Entities: Investing Through a Foreign Corporation.

Exempt organizations can also avoid the debt-financed property rules by investing in such property through a foreign corporation. In PLR 9952086, an exempt organization held 100% of the stock in a foreign corporation that invested in a foreign corporation that invested in a U.S. partnership holding debt-finance securities. The Service held that the dividends paid by the foreign corporation to the exempt organization were excluded from UBTI as dividends under Section 512(b)(2) and were not debt-financed income because the exempt organization had not incurred debt to acquire its interest in the foreign corporation.

In a series of three recent private letter rulings, the Service has again concluded that dividends received from a foreign corporation is tax-free dividend income even if the foreign corporation borrows to invest in securities. *See, e.g.*, PLR 200251016 (Sept. 23, 2002); PLR 200251017 (Sept. 23, 2002); PLR 200251018 (Sept. 23, 2002); PLR 199952086 (Sept. 30, 1999).

3. REITs.

(a) **In general.** A real estate investment trust, commonly referred to as a REIT, is a corporation that makes passive investments in real estate and is not taxed at the entity level to the extent it distributes its profits to its shareholders. It can be an attractive investment for exempt organizations because investments in debt-financed property through a REIT generally do not result in UBTI for exempt organizations. *See* Rev. Rul. 66-106, 1966-1 C.B. 151.

(b) **Requirements.** There are a number of requirements that some exempt organizations may not find acceptable. For investors willing to give up a certain amount of control, however, a REIT can be an attractive way to avoid the tax on debt-financed real estate investments.

(i) For example, by definition, a REIT must have 100 or more shareholders, I.R.C. § 856(c)(5), a requirement that makes it difficult for any single shareholder to exercise much control over investment decisions.

(ii) Moreover, section 856(h)(3) provides for recharacterizing a portion of dividends received from REITs to the extent that their income would be UBTI, if the REIT is "predominantly held by qualified trusts." A REIT is predominantly held by qualified trusts if (1) at least one qualified trust holds at least a 25% interest in the REIT or (2) one or more qualified trusts, each of which holds ore than a 10% interest in the REIT, collectively hold more than 50% of the interests in the REIT. I.R.C. § 856(h)(3)(D)(ii). Thus, the rules adopt a look-through approach for UBTI if one or a small group of qualified trusts own sufficient interests to direct the activities of the REIT.

(iii) Further, a prohibition against REITs being closely held generally would prevent exempt organizations described in section 501(c) from controlling a REIT. Generally, under section 856(h), more than 50% of the REIT cannot be held by five or fewer shareholders.

4. **Segregated Investment Trusts and Segregated Asset Accounts.** Similarly, segregated investment trusts provide a way to avoid the debt-financed property rules. In 1980, when pension funds lobbied Congress for an exception to the debt-financed property rules, one of the arguments they made was that the debt-financed property rules did not apply to common trust funds maintained by banks and segregated asset accounts maintained by insurance companies, and that this created a competitive imbalance. *Five Misc. Tax Bills: Hearings on S. 650 Before the Subcommittee on Taxation and Debt Management of the Senate Finance Comm.*, 96th Cong., 295 (1980). The regulations under section 584 were subsequently amended to provide that the debt-financed character of property held by a common trust fund "passed through" to the fund's beneficiaries. *See* Treas. Reg. § 1.584-2(c)(4) (Ex. (vi)). In 1984, Congress gave the Treasury Department regulatory authority to prevent the circumvention of section 514 through segregated asset accounts, but no regulations have yet been promulgated. *See* Tax Reform Act of 1984, P.L. 98-369, § 1034(b), 98 Stat. 494, 1039 (1984).

VIII. Corporate Sponsorship Safe Harbor Rule.

A. **Qualified Sponsorship Payments.** Section 513(i) provides that a qualified sponsorship payment (a "QSP") is not included in UBTI. A QSP is a payment made to an exempt organization by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name or logo (or product lines) of the person's trade or business in connection with the exempt organization's activities. I.R.C. § 513(i)(2)(A). As section 513(i) is a safe harbor, a payment that is not a QSP may be excludable from UBTI under a different theory or provision. At the heart of the definition of a QSP is whether the payor has received a "substantial return benefit."

B. **Use or Acknowledgement.** Use or acknowledgement, as defined in the Code and regulations, is not a substantial return benefit. Use or acknowledgment may include:

1. logos and slogans that do not contain qualitative or comparative descriptions of the payor's products, services, facilities or company;

2. a list of the payor's locations, telephone numbers or Internet address;

3. value-neutral descriptions including displays or visual depictions, of the payor's product-line or services; and

4. the payor's brand or trade names and product or service listings.

Treas. Reg. § 1.513-4(c)(2)(iii). A promotional logo or slogan that is an established part of the sponsor's identity does not, by itself, constitute advertising. Treas. Reg. § 1.513-4(c)(2)(iv)**.**

C. **Advertising.** In contrast, advertising for the payor is a substantial return benefit and generally will cause the payment to be taxable to the exempt organization. Advertising is any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement or other inducement to purchase, sell or use a sponsor's facility, products or services. Treas. Reg. § 1.513-4(c)(2)(v).

D. **Contingent Payments.** If a payment or the amount paid is contingent upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity, it is not a QSP and will be taxable income to the exempt organization receiving it, unless it is excludable from income under another theory or provision. I.R.C. § 513(i)(2)(B)(i); Treas. Reg. § 1.513-4(e)(2).

E. **Disregarded Benefits.** Benefits received by a sponsor are disregarded and thus the sponsor has not received a substantial return benefit if the aggregate fair market value of all the benefits provided by the exempt organization do not exceed two percent of the amount of the payment. Treas. Reg. § 1.513-4(c)(2)(ii). If the value of the benefits do exceed two percent of the payment, then the entire fair market value of the benefits is treated as a substantial return benefit. *Id.* Benefits include advertising, exclusive provider arrangements, goods, facilities, services, or other privileges, and the right to use an intangible asset. Treas. Reg. § 1.513-4(c)(2)(iii).

F. Payment in Excess of Return Benefit. If a corporate sponsor receives a substantial return benefit, but its payment to the exempt organization exceeds the fair market value of the benefit received, then the excess of the sponsorship payment over the fair market value of the benefit received by the corporate sponsor is treated as a QSP. Treas. Reg. § 1.513-4(d)(1).

G. Periodicals. The safe harbor for a QSP does not include any payment which entitles the payor to the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in a periodical, which is defined for these purposes as "regularly scheduled and printed material published by or on behalf of the [exempt] organization and that is not related to and primarily distributed in connection with a specific event conducted by the [exempt] organization…." I.R.C. § 513(i)(2)(B)(ii)(I).

IX. Special Considerations for the Internet.

A. Overview.

There is very little guidance on the federal income tax consequences of Internet use by exempt organizations. The Service has stated that "the use of the Internet to accomplish a particular task does not change the way the law applies to that task."[7] In many instances, however, it is difficult to apply laws and precedents written in a pre-Internet era to current Internet activities. There may be no clear counterpart to Internet activity in the non-Internet world, or the analogous activity in the Internet world may raise factors that call into question whether the pre-Internet rule should apply or how it should be applied. The UBIT area is no exception.

Recognizing that the Internet raises novel tax issues for exempt organizations, the Service issued Announcement 2000-84, 2000-42 I.R.B. 385, setting forth a number of areas in which it is "considering the necessity of issuing guidance." This announcement is helpful in identifying issues for consideration, and particularly those issues that the Service views as important. To date, however, there has been little guidance issued, and that is not likely to change in the near term. Although guidance on the application of the UBIT rules to Internet activities is in the Service's Priority Guidance Plan for 2003-2004, this item also appeared on the guidance plan for the prior year, when Steve Miller, Director, Exempt Organizations Division, indicated that the Service was not likely to issue "massive guidance" on this issue.[8]

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[7] Cheryl Chasin, Susan Ruth & Robert Harper, *Taxes and World Wide Web Fundraising and Advertising on the Internet*, CPE EO Technical Instruction Program for FY 2000, at 119.

[8] Remarks of Steve Miller, Director, Exempt Organization Division, at Western Conference on Tax-Exempt Organizations, Los Angeles, California (Nov. 21, 2002), *reported in Tax Notes Today*, 2002 TNT 228-6.

The Service did address internet issues in its Continuing Professional Education Text for Fiscal Years 1999 and 2000 (hereafter referred to as “1999 CPE Text” and “2000 CPE Text”). As indicated above, these texts are used by the Service for internal training purposes and have no precedential value. Moreover, in an area like the Internet where the Service is currently grappling with the issues, the Service’s thinking may have changed after publication of these articles. Nevertheless, in the absence of more definitive guidance, the CPE texts can be quite useful as indicators of the Service's thinking.

B. Sponsor Lists; Hyperlinks to Sponsor’s Website.

An important issue for exempt organizations has been permissible treatment for sponsors, service providers and licensees on the organization’s website. The argument that has been advanced for permitting a link to a such websites is that a link is analogous to including contact information such as the sponsor’s address and telephone number in the non-internet world. The Service has indicated implicit agreement with this approach in the QSP regulations and a recent private letter ruling.

1. **Sponsors.** In the QSP regulations, the Service has provided through an example that an exempt organization may post a list of sponsors on its website, including each sponsor's Internet address and a hyperlink from the exempt organization’s website to the sponsor’s website. The example concludes that this hyperlink constitutes an acknowledgement. Treas. Reg. § 1.513-4(f), *Ex. 11*. However if the exempt organization endorses the sponsor’s product on the sponsor’s website, the link will be treated as advertising rather than as an acknowledgement. Treas. Reg. § 1.513-4(f), *Ex. 12*. The Preamble to the regulations specifies that these examples apply only for the purpose of applying the qualified sponsorship payment safe harbor rules of section 513(i).

2. **Service Providers.** A recent private letter ruling involved a Section 501(c)(5) membership organization that had contracts with a number of service providers who offered discounts to the organization’s members. The Service held that the organization would not be engaged in a trade or business if it listed the service providers and links to the service providers’ websites on its website. The organization did not charge for the listings or the links and did not intend to do so in the future. It is not clear whether a charge for listing names or licensees and providing hyperlinks would be considered advertising for the service providers and result in UBTI. PLR 200303062 (Oct. 22, 2002).

3. **Licensees.** In the same private letter ruling, the Service held that providing a list of licensees and hyperlinks to licensee’s websites without charge would not be considered providing services and would not cause

any portion of the payments received from license's to be treated other than as royalties under Section 512(b)(2).

4. **Continued Uncertainty.** The Service's favorable guidance deals only with the limited situation where an internet address and hyperlink are provided for sponsors, service providers and licensees. As noted above, it has indicated that any endorsement will cause the link to be advertising and implicitly raised a question as to whether payment for a listing or hyperlink would cause it to be treated as advertising. This is an area where exempt organizations should continue to proceed with caution.

C. **Banners.** Websites also frequently contain moving graphically displayed links (as opposed to simple text links) which are generally referred to as banners.

1. **Generally.** As long as banners do not include any messages containing qualitative or comparative language, price information or other indications of savings or value, endorsements or inducements, then they should not be considered advertising merely because the acknowledgment draws more attention from the user than an ordinary corporate logo or simple text in link. *See* Treas. Reg. § 1.513-4(c)(2)(iii), (iv). Indeed, in the non-Internet context, sponsor logos are flashed across scoreboards and television screens without converting the sponsorship arrangement into advertising. *See* Treas. Reg. § 1.513-4(f), *Exs. 3, 4*. A different standard should not apply to websites.

2. **A Word of Caution.** Notwithstanding the existence of analogous rules in the non-Internet context, exempt organizations should be cautious in this area. Prior to issuance of the final corporate sponsorship regulations, the Service informally stated that "a moving banner is probably more likely to be classified as an advertisement subject to unrelated business income rather than a permissible statement of corporate sponsorship." 2000 CPE Text, at 132. It is not clear whether this still represents the Service's thinking on this issue.

D. **Periodicals.**

1. **Overview.** Because periodical advertising is not included in the safe harbor under the corporate sponsorship regulations and because special rules apply to computation of UBTI from periodical advertising, the question arises whether a website is, whole or in part, a periodical. Two consequences flow from the determination that a website is, in whole or part, a periodical.

(a) First, if all or part of the website is a periodical, revenue from sponsors cannot qualify as a QSP. Whether revenue is advertising or sponsorship income, related income, or some other form of income, must be determined under general principles of tax law.

(b) Second, if all or part of a website is a periodical and the revenue is derived from advertising, then it is includable in UBTI, which is computed under the special rules applicable to periodicals. *See* Treas. Reg. § 1.512(a)-1(f). These rules, written in the context of printed paper periodicals, must then be applied in the Internet context.

2. What Is a Periodical?

(a) **Regulatory definition.** For purposes of the QSP regulations, the term "periodical means regularly scheduled and printed material published by or on behalf of the exempt organization that is not related to and primarily distributed in connection with a specific event conducted by the exempt organization. For this purpose, printed material includes material that is published electronically." Treas. Reg. § 1.513-4(b). The key factor in the regulatory definition is that the "publication" is regularly scheduled. This is consistent with the common sense definition and the dictionary definition of a periodical. *See Webster's Ninth New Collegiate Dictionary*, defining a periodical as "published with a fixed interval between the issues or numbers." Some organizations post their printed paper newsletters, journals and magazines on their websites and some may dispense with the printed paper version and offer only an electronic version. This material would appear to fall within the definition of periodical.

(b) **IRS Commentary.** In Announcement 2000-84, the Service asked for comments on whether a website constitutes a single publication or communication and, if not, how it should be separated into distinct publications or communications. The Service has not issued guidance on this issue other than the definition in the regulations discussed above. Prior to the issuance of the final corporate sponsorship regulations, in the 2000 CPE Text, the Service emphasized the methodology used in preparation of website materials, stating as follows:

> ….most of the materials made available on websites are clearly prepared in a manner that is distinguishable from the methodology used in the preparation of periodicals….
>
> In considering how to treat potential income from website materials for income tax purposes the Service will look closely at the methodology used in the preparation of the website materials. The Service will be unwilling to allow the exempt organization to take advantage of the specialized

> rules available to compute UBI from periodical advertising income unless the exempt organization can clearly establish that the on-line materials are prepared and distributed in substantially the same manner as a traditional periodical.
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> This is not to say that there cannot be an on-line publication that can be treated as a periodical. While some periodicals have on-line editions and some print publications are reproduced on-line, sometimes on a subscription basis, or in a members-only access portion of a website, such materials should be and generally are, sufficiently segregated from the other traditional website materials so that the methodology employed in the production and distribution methods are clearly ascertainable and the periodical income and costs can be independently and appropriately determined. Presumably such genuine periodicals would have an editorial staff, marketing program and budget independent of the organization's webmaster.

2000 CPE Text, at 135.

(c) **Comment.** The IRS view represents a departure from section 513(i)(2)(B)(ii)(I) and the regulations, which make no mention of process or methodology. Because the final corporate sponsorship regulations are silent on process and methodology, it is not clear whether the views in the 2000 CPE Text are still current or have been superseded by the final regulations. There is still a great deal that remains unresolved in this area.

3. **Is the Income Advertising Income?** If it is determined that a website or a portion of it is a periodical, the safe harbor rule of section 513(i) does not apply and the next step is to determine whether income from the site constitutes gross advertising income. In most instances, advertising in a periodical is treated as UBTI, but the Supreme Court has left open the possibility that advertising could be related to an organization's exempt purposes. *See United States v. American College of Physicians*, 475 U.S. 834 (1989). Moreover, it is conceivable that a corporate sponsor might underwrite a series in a periodical or a particular article and not receive any return benefit other than an acknowledgement of its contribution. While this would not be governed by section 513(i), depending upon the facts and circumstances, it could be considered a sponsorship rather than advertising.

4. **How Are the Rules for Computing Advertising Income to be Applied to a Website?** If it is determined that the website or a portion of it is a periodical and that some portion of revenue received is advertising income, then the calculation of UBTI is governed by special rules for periodical advertising. In general, these rules permit the exempt organization to offset income earned from advertising by losses on the editorial side. *See* Treas. Reg. § 1.512(a)-1(f). These rules are intended to put periodicals published by exempt organizations on a level playing field with periodicals published by for-profit companies. Subscription prices for periodicals of for-profit companies are typically heavily subsidized by advertising revenue. Because the entire publication is taxed as one unit, the income from advertising is offset by losses on the editorial pages in the computation of taxable income by a for-profit company. If exempt organizations were not allowed to offset advertising income with readership losses, they would be taxed more heavily than comparably situated for-profit periodicals. In the 2000 CPE Text, quoted above, the Service seems concerned that exempt organizations may seek to obtain the advantage of these rules by claiming their websites are periodicals. In practice, it seems just as likely that exempt organizations will want to claim their websites are not periodicals and seek to come within the safe harbor of the QSP regulations.

5. **General Website Advertising Provided to Periodical Advertisers.** The Service addressed periodical advertising in PLR 200303062 (Oct. 22, 2002). There, a Section 501(c)(5) organization offered general website advertising for no additional charge to advertisers in its paper periodical. The Service held that no allocation was necessary between the periodical advertising (which qualified for the special computational rules) and the website advertising (which did not qualify). The Service indicated, however, that if the advertiser had paid for the web advertising, then it would be necessary to make an allocation, as part of the payment would qualify for the special periodical rules and part would not. The Service further indicated that if the website was a periodical then no allocation would be necessary, as the special rules would apply to both the paper periodical and the website periodical advertising.

E. E-commerce.

1. Direct Sales of Merchandise on an Exempt Organization's Website.

(a) Online Stores. Many exempt organizations have stores on their websites where they sell goods that are similar to the goods sold in their catalogs or bricks-and-mortar stores or shops.[9] Whether

[9] Some organizations have found online stores to be very profitable. *See E-Commerce: Charitable groups discover new revenue in retailing goods via their own Web sites*, N.Y. Times, Mar. 27, 2000.

income from these sales is taxable depends upon the same UBIT analysis that applies to sales through a catalog or store. 2000 CPE Text, at 127.

(b) Application of UBIT Rules. As discussed above, except in certain circumstances, an activity will give rise to UBTI if it is (1) a trade or business; (2) that is regularly carried on; and (3) that (aside from the organization's need for funds) is not substantially related to the organization's exempt purpose. I.R.C. §§ 512(a), 513(a). Most online stores will likely be considered trades or businesses (i.e., operated to make a profit) that are regularly carried on, and taxation will turn on whether they are substantially related to the organization's exempt purpose. Under the fragmentation rule, each item in an organization's store must be examined to determine if it is substantially related to the organization's exempt purpose. I.R.C. § 512(c); Rev. Rul. 73-105, 1973-1 C.B. 264.

2. Relationships with Other Websites.

(a) Links for Order Processing. Some organizations' websites link to another website for purposes of fulfillment. For example, an organization that sells books on its website may fulfill orders through one of the large online bookstores such as Barnes and Noble or Amazon.com (the "Fulfillment Website"). When a customer chooses to purchase a book on the exempt organization's website, he or she is linked to the Fulfillment Website. If the exempt organization simply receives a portion of the revenue from the sale of the book (*e.g.*, sales price less a commission payable to the Fulfillment Website), then whether the income is taxable would depend upon whether the organization is engaged in a trade or business regularly carried on and whether the book is related to the organization's exempt purpose, as discussed above.

(b) Other Links. In some agreements, however, the exempt organization receives a payment for any other purchases its customer makes after being linked to the Fulfillment Website. Alternatively, an exempt organization may provide a link from its website to another website without regard to the sale of its own products. It may provide the link for any number of reasons. For example, the link may take users to a website that promotes the same exempt purpose as the referring exempt organization; it may be a link to a sponsor's site; or, it may be a link provided for the purpose of earning revenue.

(c) Analysis. From a business standpoint, the relationship is often somewhat similar to an exempt organization's rental of its mailing list and licensing of its name and trademark. As with an organization renting a mailing list from an exempt organization, the referred website is seeking a way to offer its products or services to the exempt organization's constituency and, as with a license agreement, the referred website is seeking to benefit from the use of the exempt organization's name and trademark. While this analogy has some merit from a business standpoint, it is not a clean analogy for legal purposes. There is no mailing list and the exempt organization has not granted the organization the right to use its name but rather has granted it a place in its cyber real estate. The most likely result is that the revenue will be treated as a taxable referral fee. In some cases, the referring organization may be able to argue that the referral is substantially related to its exempt purpose. As noted above, in the case of a link to sponsor's website, the fee will not be a QSP if it is based on the traffic referred by the exempt organization's website or the purchases made by the exempt organization's users.