F. UPDATE ON UNRELATED BUSINESS TAXABLE INCOME

1. Introduction

The purpose of this topic is to update previous CPE text discussions concerning developments in the area of unrelated business income. Continuing Congressional interest in UBI will be noted, but the topic will focus on recent court decisions. The decisions have been grouped, for the most part, into three perennial areas of controversy: social clubs, advertising, and insurance.

2. Congressional Action

The CPE Texts for 1987, 1988, and 1989 describe the comprehensive review of the area of unrelated business income tax being conducted by the Oversight Subcommittee of the House Ways and Means Committee. In summary, five days of hearings were held in June of 1987; a series of discussion options were released for public comment in March of 1988; an additional day of hearings was held in May of 1988; and, proposed draft recommendations were forwarded by the Chairman of the Subcommittee to the members in June of 1988. During the past 18 months the Oversight Subcommittee has continued its review but has not yet made a final report to the full Committee.

On September 7, 1989, Congressmen Rostenkowski, Archer, Pickle, and Schulze wrote a letter to Kenneth W. Gideon, the Assistant Secretary of the Treasury for Tax Policy. The letter stated that the Congressmen view the final resolution for improvements in the unrelated business income tax to be a priority matter for the Ways and Means Committee. The Congressmen noted that the draft recommendations were developed in consultation with the prior administration and requested the official position of the current administration. The Congressmen stated that knowing the current Treasury position on these issues will enable the Subcommittee and Committee to move forward to reform the law.

As last year's CPE Text noted, whether any legislative changes will emerge from this Congressional review remains to be seen.

3. Social Clubs

Background

Both the 1988 CPE text beginning at p.89 and the 1989 text beginning at p.27 discussed the on-going litigation arising in connection with attempts by social clubs to deduct from investment income losses from food and beverage sales to nonmembers. In accordance with Rev. Rul. 81-69, 1981-1 C.B. 351, when an exempt social club's sales of food and beverages to nonmembers are not "profit motivated," the club may not deduct losses from such sales to nonmembers against its net investment income. A social club will fail this profit motive test if its prices are insufficient to recover costs and, as a result, the club consistently shows only losses from the activity. A number of organizations have challenged the validity of Rev. Rul. 81-69.

Litigation has resulted in conflicting court of appeals cases in the Second and Sixth Circuits. In Cleveland Athletic Club v. United States, 779 F.2d 1160 (6th Cir. 1985), the court held that a social club may net the excess expenses attributable to sales of food and beverages to nonmembers against its investment income. In The Brook, Inc. v. Commissioner, 799 F.2d 833 (2d Cir. 1986), the court held that a social club could not use its losses from sales of food to nonmembers to write off a portion of its gross income from investments. The Sixth Circuit based its holding on the social club's activities having a basic purpose of economic gain, while the Second Circuit was persuaded by the club's stipulation that it had no profit motive when it engaged in the activity of selling meals to nonmembers. The Tax Court has sided with the taxpayer on this issue in two cases, North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987), and Portland Golf Club v. Commissioner, T.C. Memo 1988-76. Both of these cases were appealed to the Ninth Circuit Court of Appeals.

A. North Ridge Country Club v. Commissioner

In the past year, the Service has continued to litigate the issue presented in Rev. Rul. 81-69 with mixed results. In three lower court cases the Government's position was rejected. University Club of Cincinnati, Inc. v. United States, C-1-88-0443 (S.D. Ohio 1989), and Detroit Athletic Club v. United States, 717 F. Supp. 1224 (E.D. Mich. 1989), two cases arising in the Sixth Circuit, were decided in accordance with Cleveland Athletic Club, supra. In Inter-Com Club, Inc. v. United States, CV88-L-39, (D. Neb. 1989), a case of first impression in the Eighth Circuit, the District Court for Nebraska held that losses from a nonmember activity may be deducted against investment income when the activity is carried on for the production of income even though the activity is not profit motivated. Under the court's production of income test, nonmember income must exceed variable expenses directly connected with the activity. Having met this test, the Inter-Com Club was allowed to deduct variable

expenses as well as an allocated portion of fixed costs directly connected to nonmember use of the club, even though a net loss resulted from the activity. At this writing, both Detroit Athletic Club and Inter-Com Club have been appealed, but decisions have not been reached.

The Government's losing streak on this issue ended, however, in North Ridge Country Club v. Commissioner, 877 F.2d 750 (9th Cir. 1989), when the Ninth Circuit Court of Appeals reversed the Tax Court and sided with the government.

Facts

North Ridge Country Club is a social club recognized as exempt from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(7). The club operates a golf club, a restaurant and bar, and other facilities for the benefit of members and guests. In 1979, the year at issue, the club obtained revenues from membership dues and fees, but also from three nonmember sources. One source of nonmember revenue was interest from a savings account. Another source was nonmember golf tournaments, in which the club charged a variety of user fees and produced food and bar revenues from obligatory post-tournament banquets. A third source was food and bar earnings from nonmember banquets unrelated to golf tournaments.

In calculating the profitability of nonmember activities, the club only took into account "direct expenses," i.e., those which would not have been incurred but for the activity (e.g. additional labor costs and cost of goods sold). Based on such an analysis, 1979 produced overall nonmember profits. The club sought to generate these "profits" from nonmember activities to produce cash flow and contribute to its "indirect expenses," i.e. fixed or quasi-fixed expenses such as overhead.

For tax purposes, however, the club did take into account indirect expenses in determining the profitability of its nonmember activities. During the five years prior to 1979, interest income and nonmember golf tournaments generated profits for the club, while food and beverage sales to nonmembers showed consistent losses. For each year, the losses were significant enough that when all nonmember activities were aggregated, an overall loss resulted.

The Tax Court determined that the club was engaged in all of its nonmember activities with the intention of making a profit. Therefore, losses from one of the club's nonmember activities could be deducted against the revenue from another. This finding was based on the incremental increase of funds available to the club from

each dollar earned over the direct costs of such activity. The government argued that each activity should be analyzed to determine whether a profit motive exists. In the government's view, since the Club is allowed to deduct both direct and indirect costs associated with an activity, such amounts should be considered in determining whether the activity is profit motivated.

Holding

The court agreed with the Second Circuit's decision in The Brook, Inc., supra, and held that a social club must pursue a nonmember activity with a profit motive before it can properly deduct its losses under IRC 512(a). The court based its conclusion on the fact that the club had not shown it could be entitled to deduct losses under any provision of the Code, unless under IRC 162, which requires a profit motive, and specifically rejected the Sixth Circuit's holding in Cleveland Athletic Club, supra, that deduction of losses is allowed upon a showing of intent to derive "economic gain."

In the legislative history, the court found support for the proposition that Congress sought, in enacting IRC 512(a), to eliminate the difference between the tax treatment afforded individuals seeking independent recreation, and the treatment given to those seeking recreation through a social club. The court felt it was contrary to this purpose to read IRC 512(a) to allow social clubs to deduct losses in activities not entered into for profit, while denying individuals the same deduction.

Further, the court concluded that the term "profit," as used in this context, means the production of gains in excess of all direct and indirect costs. Thus, the Tax Court erred in holding that tax profit should be viewed from the standpoint of "an incremental increase in available funds" to the club.

Postscript

In a related disposition, Portland Golf Club v. Commissioner, supra, was remanded to the Tax Court for a determination of whether the Portland Golf Club engaged in its nonmember activities with the intent required under North Ridge to deduct its losses from those activities. On September 28, 1989, the Portland Golf Club filed a petition for certiorari with the Supreme Court based on the active conflict in the Circuits.

At this time the Service position, as expressed in Rev. Rul. 81-69, should be applied in all cases, even in cases arising in the venue of the Sixth Circuit.

B. Phi Delta Theta Fraternity v. Commissioner

The 1989 CPE Text at pp.29 and 56 discussed the case of Phi Delta Theta Fraternity v. Commissioner, 90 T.C. 1033 (1988). On October 24, 1989, the judgment of the Tax Court in favor of the Government was affirmed in Phi Delta Theta Fraternity v. Commissioner, No. 88-1863 (6th Cir. Oct. 24, 1989).

Facts

Phi Delta Theta Fraternity is a national college fraternity exempt from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(7). The fraternity publishes a quarterly journal which is circulated predominately to alumni and undergraduate fraternity members. Described in its masthead as an educational journal, the magazine has an editorial policy of informing its readers of developments and issues within the fraternity, providing information on the achievements of the fraternity's undergraduate and alumni members, and providing educational information about society and higher education. Although the magazine occasionally publishes articles on alcoholism and drug abuse, hazing, or safety, most of its articles concern awards received by members and achievements of alumni.

Publication costs of the magazine are paid with funds obtained from an endowment fund. Rules governing the endowment fund provide that money in the fund may be used to pay expenses incurred to administer the trust; expenses incurred for editing, printing, and publishing the fraternity's periodical publications; and, any other necessary expenses of the fraternity.

Issue

Whether the net investment income from the endowment fund used to pay publication costs of the journal constitutes exempt function income within the meaning of IRC 512(a)(3)(B) that may be excluded from the fraternity's unrelated business taxable income.

Rationale and Holding

IRC 512(a)(3)(B)(i) provides that the term "exempt function income" includes income which is "set aside" by a social club for a purpose specified in IRC 170(c)(4) (which includes a purpose that is "exclusively" educational). Given the statutory language, the court first sought to determine whether the income from the endowment

fund was properly "set aside" within the meaning of IRC 512(a)(3)(B). From analogous tax regulations the court developed two "tests" to determine what constitutes a proper set aside within the meaning of IRC 512(a)(3)(B): First, the amount to be set aside may not be commingled with any amount which is not to be set aside; and, second, the possibility that amounts set aside will be used for some other purpose must be so remote as to be "negligible." Applying these tests to the case at hand, the court concluded that the fraternity had not properly set aside the funds to be used for the magazine because the money had been commingled with funds available for other purposes and, given the rules governing the use of the endowment fund, the possibility that the fund would be used for nonpublication purposes was not negligible.

The court then considered the fraternity's argument that any income from the fund actually spent on the educational portions of the magazine should be considered "exempt function income" based upon the percentage of the publication which is devoted to education. The court rejected this contention because IRC 512(a)(3)(B) requires investment income to be "set aside" for an exempt purpose not "actually spent" on an exempt purpose. The court further determined that the investment income used to publish the magazine had not been used "exclusively" for an exempt purpose within the meaning of IRC 170(c)(4) because the journal was not "exclusively" educational. Therefore, no part of the funds "actually spent" on the magazine was exempt function income.

The failure of the fraternity to properly set aside the income within the meaning of IRC 512(a)(3)(B)(i) and to use the funds exclusively for exempt purposes within the meaning of IRC 170(c)(4) led the court to conclude that investment income earned by the endowment fund was unrelated business taxable income.

4. Advertising

Background

Last year's CPE Text beginning at p.23 discussed four separate opinions issued by the U.S. District Court for the Northern District of Illinois in a case involving the American Medical Association. The case began as a technical dispute as to the proper interpretation of the advertising regulations, but resulted in a significant provision of the regulations being invalidated on procedural grounds. The district court's judgment concerning the validity of the regulations as well as some of the substantive technical issues considered in the court's first opinion was appealed to the Seventh Circuit Court of Appeals. In light of the continuing controversy surrounding the advertising

regulations, and the intricacy of the issues involved in some of the recent cases, it may be useful to review the statutory and regulatory scheme for taxing the advertising income of exempt organizations.

Under IRC 513(c) an exempt organization's publications are divided (under the so-called "fragmentation principle") into two components: (1) the tax-exempt publication of the periodical's editorial or "readership content" and (2) the taxable enterprise of selling and publishing advertising.

Detailed regulations govern the allocation of revenues and expenses between these two components. Reg. 1.512(a)-1(f)(6) provides for the division of a periodical's costs into two categories:

> (ii)(a) The direct advertising costs of an exempt organization periodical include all expenses, depreciation and similar items of deduction which are directly connected with the sale and publication of advertising. . . The items allowable as deductions under this subdivision do not include any items of deduction attributable to the production or distribution of the readership content of the periodical.
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> (iii) The "readership" costs of an exempt organization periodical include expenses, depreciation or similar items which are directly connected with the production and distribution of the readership content of the periodical. . . [R]eadership costs include all the items of deduction attributable to an exempt organization periodical which are not allocated to direct advertising costs under subdivision (ii). . .

"Direct advertising costs" are fully deductible from gross advertising income while "readership costs" are only deductible from gross advertising income to the extent they exceed "circulation income."

"Circulation income" is defined in Reg. 1.512(a)-1(f)(3)(iii) as:

> the income attributable to the production, distribution or circulation of a periodical (other than gross advertising income) . . . Where the right to receive an exempt organization periodical is associated with membership . . . in such organization for which dues . . . are received (hereinafter referred to as "membership receipts"), circulation income includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as "allocable membership receipts").

Thus, "circulation income" consists of both direct sales (usually sales to nonmember subscribers) and sales as a portion of membership dues.

The regulations go on to explain that "allocable membership receipts" should generally represent the amount which a taxable organization would have charged for the periodical in an arms-length transaction with the member. Reg. 1.512(a)-1(f)(4) provides a discussion of the factors to be considered in determining allocable membership receipts and provides methods for determining the share of membership receipts which should be deemed to constitute a member's payment for the right to receive the periodical. If 20% or more of the "total circulation" of a periodical consists of sales to nonmembers, the subscription price charged to such nonmembers shall determine the price of the periodical for purposes of allocating membership receipts to the periodical. Reg. 1.512(a)-1(f)(4)(i). If less than 20% of the magazine's total circulation consists of sales to nonmembers, the regulations allocate membership dues to circulation income based on a pro rata formula. Reg. 1.512(a)-1(f)(4)(iii). The pro rata allocation method states:

> [T]he share of membership receipts allocated to the periodical... shall be an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization.

A. American Medical Association v. United States

In American Medical Association v. United States, No. 88-3012 (7th Cir. October 12, 1989), a decision was reached by the court of appeals that reversed, in part, and affirmed, in part, the district court's decision.

Facts

The American Medical Association (AMA) is an exempt membership organization described in IRC 501(c)(6). Between 1975 and 1978, the AMA published two periodicals which contained articles relevant to the practice of medicine. AMA members receive the periodicals at no cost as a membership benefit. Less than 20% of the total circulation of the periodicals consisted of sales to nonmembers. The AMA also sold advertising in the periodicals to help defray publication costs. In order to increase advertising revenues, the AMA distributed copies of the periodicals free-of-charge to targeted groups of physicians (the "control

group") who made up an especially desirable audience for firms likely to advertise in the publications. Many of these physicians were AMA members who already received the publications.

From 1975 through 1978, the AMA placed a portion of its dues into an "association equity" account to be used as a reserve in the event of a shortfall. The AMA maintained the account until 1985 when the organization withdrew the funds to compensate for a shortage in revenues.

Issues

The case presented the following issues involving the allocation of income and expenses between the exempt and taxable aspects of the AMA's periodicals:

(1) Whether the allocation regulations are invalid either because the Service did not comply with the notice and comment requirements of the Administrative Procedure Act (APA) in promulgating the rules, or because the rules conflict with the statutory provisions governing the unrelated business income tax;

(2) Whether the costs of producing and distributing the readership content of periodicals distributed free of charge to nonmember physicians in the "control group" should be treated as fully deductible direct advertising costs, or as partially deductible readership costs;

(3) Whether, in calculating membership receipts allocable to circulation income under the pro rata method of allocation (Reg. 1.512(a)-1(f)(4)(iii)), dues placed in the "association equity" fund rather than used to pay activity costs should be included in total membership receipts; and,

(4) Whether, in calculating membership receipts allocable to circulation income under the pro rata method of allocation, dues collected from AMA members in the control group who would have received the periodical free of charge even if they had not been dues-paying members should be included in total membership receipts.

Issue 1

The AMA argued, generally, that the rules governing the allocation of a portion of membership dues receipts to circulation income are invalid because the public did not receive adequate notice of the Service's regulatory intentions before the final rules were issued.

The court agreed with the district court's determination that the final regulations worked a substantial change to what was originally proposed in the notice of proposed rulemaking, but did not agree with the district court's holding that this change rendered the regulations invalid under the APA. The court found that the promulgation of the regulations had satisfied the requirements of the APA, regardless of the rules ultimately adopted, because the parties affected by the final rules were put on notice that their interests were at stake and had a reasonable opportunity to comment.

In the alternative, the AMA contended that the allocation rules are invalid because they conflict with IRC provisions governing the unrelated business income tax. While conceding that the alternative allocations offered by the AMA were "reasonable," the court found that the AMA had not carried the burden of demonstrating that the allocations required by the regulations were "plainly inconsistent" with the Code.

The court, therefore, reversed the district court's determination that the regulations were invalid.

Issue 2

The court rejected the Government's argument that a "purely objective standard" be applied under the definition of "direct advertising costs," i.e., if the expense relates to the production or distribution of the journal's articles, it is a "readership cost" deductible from advertising income only if circulation income is negative; if the expense relates to the production or distribution of advertising it is a "direct advertising cost" and fully deductible from advertising revenue. Under this standard, the cost of producing the editorial content of a periodical is "per se" a readership cost and can NEVER be a direct advertising cost, even where it is undisputed that the expense was incurred only to promote the organization's advertising business. Under this reading of the regulations, the subjective intent of the AMA in incurring any particular expense is irrelevant to the categorization of the expense as a readership or advertising cost.

In finding the Government's position overly restrictive, the court determined that Reg. 1.512(a)-1(f)(6) could be read to permit the deductibility of readership costs where such costs are motivated SOLELY by an intent to increase advertising revenues. From the evidence presented, the court believed it was "absolutely clear" that the costs would not have been incurred but for the AMA's desire to increase its advertising business. Therefore, the court affirmed the district court's judgment that expenses associated with the production of the readership content of copies of the AMA's journal distributed to control group members were fully deductible as "direct advertising costs."

Issue 3

The AMA argued that when membership dues are not used to meet current expenses they should not be counted to determine the amount of membership dues which should be considered a member's right to receive the organization's periodicals. According to the AMA, the underlying premise for the "pro rata allocation method" is that membership receipts and gross advertising income are equally available for all of the exempt activities of the organization, including the periodical. When a portion of the dues is set aside to meet future expenses and, therefore, is not "available" to pay current expenses, that portion should be excluded from the pro rata calculation.

The court disagreed with this argument. In the court's view, the existence of the "association equity" fund meant only that the AMA operated, in effect, at a "profit," i.e., members paid more for their benefits, including the right to receive the organization's periodicals, than it cost the AMA to provide. The fundamental premise of the "pro rata allocation method," under the court's analysis, is that the activities of an exempt organization produce revenue in the same proportion that the costs of those activities bear to one another. This premise is valid whether all membership receipts are actually expended to meet activity costs or not. Therefore, it is entirely consistent with the regulations to allocate all membership receipts to exempt activities even where revenues exceed expenses for purposes of determining "circulation income."

The court also disagreed with the AMA's suggestion that the excess dues placed in the "association equity" account were similar to capital contributions. The problem with this analogy, in the court's opinion, is that the AMA's members received no "continuing benefit" from their payments into this account that would be similar to the "continuing interest in a business enterprise" purchased by a capital contributor. Therefore, the funds placed in the association equity account were

current income of the AMA and should be allocated as revenue to the AMA's various activities in accordance with the pro rata allocation method. The court further noted that failure to recognize as income in the current year those monies set aside in the equity account would be contrary to the general rule that income must be recognized when the recipient has the unrestricted right to use the funds.

Accordingly, the court reversed the district court's determination that funds placed in the AMA's "association equity" were not "allocable membership receipts" for purposes of determining the AMA's circulation income.

Issue 4

The AMA made three arguments in support of its view that membership dues should not be allocated to circulation income when a dues-paying AMA member was entitled to receive complimentary copies of the organization's periodicals through the AMA's "controlled circulation": (1) these members should not be deemed to have paid for a periodical which they were entitled to receive free of charge; (2) the AMA's circulation income would no longer approximate the amount that would be charged and paid by members if the periodical was that of a taxable organization published for profit; and, (3) since members of the control group must have known that they were entitled to the periodicals regardless of membership, they must have intended their dues payments to apply only to the AMA's other activities.

In the court's view, the relevant inquiry was whether the AMA retained the full amount of the dues paid by the control group physicians, or had returned that portion of their dues representing the cost of the periodicals. In the absence of any indication to the contrary, the court concluded that the entire dues were retained by the AMA for use in its activities. Therefore, these physicians, in fact, paid for the periodicals whether they needed to or not. Further, the court was not convinced that a taxable organization would have reduced circulation income by voluntarily returning unnecessary payments made by ill-informed subscribers. While the court was apparently willing to consider the motivation of the control group/AMA members in paying their dues, it found nothing in the record to support the position that these physicians intended to support only activities other than the periodicals. Therefore, the court affirmed the district court's conclusion that dues from members who were also in the control group should be allocated to circulation income to the same extent as the dues of other AMA members.

B. North Carolina Citizens for Business and Industry v. United States

Another case involving the proper interpretation of the advertising regulations was considered by the U.S. Claims Court in North Carolina Citizens for Business and Industry v. United States, No. 617-84 T (Cl. Ct. Aug. 28, 1989).

Facts

North Carolina Citizens for Business and Industry (the "Association") is exempt from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(4). The Association publishes a monthly magazine which reports on political, business, economic, governmental, and cultural affairs of the state. In 1979, annual membership dues ranged from $ 150.00 to $ 4,000.00, depending on the number of employees of the member. For every $ 50.00 in dues paid in 1979, a member was entitled to receive one subscription to the magazine. Thus, the number of copies purchased by each member was determined by the amount of dues. The member then designated a person or institution to receive, without further charge, the copy of the publication purchased by dues. In addition to copies of the magazine purchased by dues, the Association also sold annual subscriptions and single copies to nonmembers.

During 1979, the Association had 1,230 dues-paying members and, each month, sent out 8,157 copies of the magazine to members and their designated recipients. In the same year, approximately 1,088 copies of the magazine were sent out each month to nonmember paid subscribers.

In determining unrelated business income from the sale of advertising in the magazine, the Association contended that the "total circulation" of the magazine for purposes of determining the portion of membership dues allocable to circulation income should include only those 2,318 customers actually paying for the magazine. Otherwise, the Association contended, the regulations are generally inconsistent with the IRC and, therefore, invalid.

Issues

(1) Whether the "total circulation" of the magazine should include multiple copies purchased automatically by members as part of their dues for purposes of determining the appropriate method of allocating the Association's membership dues to circulation income.

(2) If so, whether the advertising regulations are inconsistent with the IRC and, therefore, invalid.

Issue 1

In the court's view, the Association's approach would run counter to the purpose of the regulations which is to approximate the fair market value of the magazine and allocate that portion of membership dues to "circulation income." Under the regulations, if more than 20% of the magazine's "total circulation" is from sales to nonmembers the amount paid by nonmembers is deemed to approximate fair market value. However, when a significant portion of paid subscriptions are excluded from "total circulation," sales to nonmembers may not represent a reliable measure of the periodical's actual market value. Under these circumstances, the court noted, the organization may keep the subscription price artificially low by subsidizing the magazine's cost with membership dues. Therefore, the court held that the AMA's "total circulation" must include magazines purchased with additional dues.

Issue 2

The court determined that the advertising regulations are reasonable and consistent with the IRC and, therefore, valid. The court further held that it lacked jurisdiction to consider the Association's argument that the regulations were improperly promulgated.

C. National Collegiate Athletic Association v. Commissioner

In National Collegiate Athletic Association v. Commissioner, 92 T.C. 27 (1989), the Tax Court considered whether the sale of advertising to be published in programs for the National Collegiate Athletic Association's annual men's basketball championship tournament was subject to tax as unrelated business income.

Facts

The National Collegiate Athletic Association (NCAA) is an unincorporated association of more than 800 members consisting of colleges, universities, athletic conferences and associations, and other educational organizations and is exempt from federal income tax under IRC 501(a) as an organization described in IRC 501(c)(3).

The NCAA annually sponsors championship games, meets, or tournaments for men or women in various sports, including basketball. Game programs which set forth the participants and other tournament-related information are usually published and sold in conjunction with these events. NCAA regulations authorize the actual printing of such programs and selling of advertising therein to "an outside agency

under contract, the host institution, or the NCAA national office." The regulations further state, "If the program is printed by an outside agency, the Association shall receive a guaranteed amount or a predetermined percentage of program receipts."

The 1982 men's basketball tournament was held on eight separate days in March spanning approximately three weeks. It was an elimination tournament consisting of regional rounds played at various locations across the country and culminating with the semi-final and final games involving the top four teams (the Final Four). Forty-eight college teams were invited and participated. In connection with the tournament, the NCAA contracted in both a written contract and an oral agreement with a commercial publisher for the publication and sale of programs, including advertising.

The NCAA's involvement with the publisher was limited to recommending some story ideas about the tournament or authors to write those stories and reviewing whether a couple of proposed advertisements met the conditions of the contracts on acceptable advertisements in programs. At the conclusion of the tournament, the publisher presented a detailed financial report regarding the revenue generated from the sale of programs and advertisements, at which time the NCAA was paid its share of the receipts.

Issues

(1) Whether income from the sale of advertising in the tournament program constitutes income from an unrelated trade or business "regularly carried on" within the meaning of IRC 512(a) and, if so,

(2) Whether the income may be excluded as royalty income under IRC 512(b)(2).

Issue 1

The NCAA argued that its advertising activities were not regularly carried on because its role in the sale of the advertising was "passive." In support of this contention, the NCAA asserted that the facts and circumstances failed to establish a principal-agent relationship between it and the publisher. Further, the NCAA argued that annual sporting events such as the tournament in this case should be deemed intermittent and not regularly carried on under Reg. 1.513-1(c)(2).

The Government took the position that "seasonal" events such as sports championships are normally carried on only during part of the year or once a year

and, therefore, are regularly conducted even if they are only held during part of the year or once a year. The Government also argued that the advertising activities should be viewed in the larger context of the NCAA's extensive actions in planning and conducting the tournament because there would be no program or advertising revenues therefrom without the tournament. Finally, noting that the NCAA had the right of final approval for all advertising in the program, the Government contended that the presence of such legal rights, and not the actual exercise of them, should be the critical factor in determining the level of the NCAA's activity.

The Tax Court felt that the issue should not be decided solely with reference to the tournament itself since the distinct "trade or business" in question is the sale of advertising which is "severed" by IRC 513(c) from the circulation of the program and the NCAA's overall activity of conducting the tournament. The court determined that, under the terms of the contract, an agency relationship existed between the NCAA and the publisher. Therefore, the activities of the publisher should be attributed to the NCAA.

In the absence of evidence to the contrary, the court concluded that the publisher's conduct with respect to the sale of advertising was typical of any commercial endeavor (i.e., regularly carried on) and was not intermittent within the meaning of Reg. 1.513-1(c)(2)(ii). Therefore, the court held that the NCAA's receipts from the sale of tournament program advertising constituted income from an unrelated trade or business regularly carried on within the meaning of IRC 512(a).

Issue 2

In an argument similar to that presented on the previous issue, the NCAA maintained that its advertising income was "passive" in nature and, therefore, in the nature of a royalty for the right to publish and sell the tournament programs, including the advertising. Citing Rev. Rul. 81-178, 1981-2 C.B. 135, the NCAA further contended that the passive nature of the income was not changed by its right under the agreement to approve the quality of the advertisements.

Based on its determination that the agreements between the NCAA and the publisher were agency agreements, the court concluded that the NCAA's role was not passive. The court distinguished the licensing agreements in Rev. Rul. 81-178 which merely authorized the businesses to use and exploit certain valuable rights, such as trademarks. In contrast, the agreements in this case imposed a duty on the publisher to perform certain services on behalf of the NCAA. Therefore, the court held that the

advertising income may not be excluded as a royalty under IRC 512(b)(2). (For a further discussion of "royalties" see the 1989 CPE text at p.31.)

The NCAA has appealed to the Tenth Circuit.

D. West Virginia State Medical Association v. Commissioner

The 1989 CPE Text at p.26 discussed the decision in West Virginia State Medical Association v. Commissioner, 91 T.C. 41 (1988). The case concerned an exempt medical association described in IRC 501(c)(6). The association publishes a medical journal containing paid advertising, but has not made a profit on its advertising since 1962. In 1983 the association had unrelated business taxable income of $ 9,908 from commissions for endorsing a collection service for doctors and attempted to offset this commission income with a loss of $ 21,810 attributable to its advertising activity. Under these circumstances, the Tax Court held that the sale of advertising was not a "trade or business" within the meaning of IRC 512(a)(1) because it lacked a profit motive. Therefore, expenses incurred in the activity were not deductible under IRC 162 and losses could not be used to reduce unrelated business income. The organization appealed.

In West Virginia State Medical Association v. Commissioner, 882 F.2d 123 (4th Cir. 1989), the court of appeals affirmed the decision of the Tax Court. The appeals court agreed that the phrase "trade or business" used in IRC 512(a)(1) has the same meaning as in IRC 162. Based on the organization's long-standing policy of voluntarily incurring losses, the court concurred with the Tax Court's conclusion that the association's advertising activity lacked the requisite profit motive to be considered a trade or business.

5. Insurance

Background

Past CPE texts have examined various arrangements whereby an exempt organization (in most cases an IRC 501(c)(5) or IRC 501(c)(6) organization) acts as a group insurance policyholder for its members. In addition to serving as the group policyholder, the exempt organization agrees to perform assorted administrative duties in connection with the insurance program. The income to the organization may be in the form of fees from the insurance company for insurance promotion, a percentage of the premiums collected, or experience rating reserve funds. The Service position has consistently been that the income received by the exempt organization

from the insurance program is unrelated business taxable income. This position was upheld by the United States Supreme Court in United States v. American Bar Endowment, 477 U.S. 105 (1986). (See the 1987 CPE Text at p.9.)

A. National Water Well Association, Inc. v. Commissioner

In National Water Well Association, Inc. v. Commissioner, 92 T.C. No. 7 (January 24, 1989), the Tax Court considered an insurance program endorsed and sponsored by an exempt business league described in IRC 501(c)(6).

Facts

The National Water Well Association, Inc. (the "Association") has approximately 8,000 members composed of individuals and organizations involved in the business of water well drilling. The Association sponsors various insurance programs for its members.

At one time, water well drillers were classified, for insurance purposes, in the same category as oil well drillers. As a result of a study conducted by the Association, it was determined that, in fact, water well drillers had a better safety record than oil drillers and should be classified separately. As a result of this new classification, an insurance company developed a casualty insurance program for the water well industry.

The Association became the group policyholder for the program and entered into a written agreement with the insurance company in which the Association agreed, generally, to assist the insurance company in endorsing, promoting, and sponsoring the insurance program. The Association also agreed not to sponsor or endorse any other property or casualty insurance program and not to allow its list of property or casualty insured risks to be disseminated to other parties for purposes of direct or indirect solicitation for any other property or casualty insurance program. In fulfilling these contractual obligations, the Association wrote articles on safety and its effects on insurance, provided exhibit space for the insurance company at its conventions and meetings, and answered inquiries from present and potential policyholders regarding the insurance.

During 1980 the Association received a dividend from the insurance company. The Association was under no obligation to distribute the dividend to the individual members, but decided to distribute a portion of the dividend to those insured under the policy on a pro rata basis based on the percentage of the total premium that each

had paid. A portion of the retained dividend was used by the Association's Safety Committee to promote safety in the water well industry through educational programs and publications.

Issues

(1) Whether the insurance dividends received by the Association constitute income from a trade or business regularly carried on that is not substantially related to the organization's exempt purposes and, if so,

(2) Whether the income may be excluded from unrelated business income tax under IRC 512(b)(2) as royalties.

Issue 1

The Association argued that the dividend was not unrelated business taxable income because the activity from which the income was derived is not a trade or business. In the alternative, if it was a trade or business, the activity was substantially related to its exempt purpose.

The court noted that in prior cases it had applied a "profit motive" test to determine whether an activity constitutes a trade or business for purposes of IRC 512. Under the profit motive test an activity constitutes a trade or business if the organization's motive or intent for engaging in an activity is the production of income. From the fact that the association was extensively involved in endorsing and administering a program that proved highly profitable, the court inferred the requisite profit motive. The fact that the association could unfairly compete with taxable commercial organizations that could provide the Association's members and others in the water well industry with casualty insurance further bolstered the court's conclusion that the activity constituted a trade or business.

In order to determine whether the insurance program was substantially related to the Association's exempt purpose, the court first looked generally to the conduct and intent of the organization. The court found that the Association may have intended to support the mutual interests and welfare of the water well industry as a whole when it first undertook to separate water drillers from oil well drillers for insurance purposes. Once the insurance program was in place, however, the Association's role in that program (i.e., providing services for one particular insurance company) no longer, in the court's view, advanced the interests of its members or the water well industry as a group. Further, any exempt purpose served by the

Association's articles on safety and its effects on insurance written under contract to the insurance company was incidental to the Association's purpose of fulfilling its contractual obligations.

Next, the court looked to Reg. 1.501(c)(6)-1, to develop a test geared specifically to organizations exempt under IRC 501(c)(6). The court concluded that a substantial relationship to the exempt purpose of a business league does not exist if the business league's activity includes only the performance of particular services for individuals in proportion to the money they pay. Since only those individuals who paid premiums received insurance under the insurance program, the insurance program did not meet this test. Thus, the court held that the Association's income from the insurance program constituted income from an unrelated trade or business.

Issue 2

The association argued that the income it received from the insurance company was royalty income because its activities with respect to the insurance company were passive. The court found, based on the extensive services performed by the Association under contract to the insurance company, that the association, in fact, played an active role in the program. Therefore, the court held that the income received was similar to compensation for services and not royalty income.

B. Professional Insurance Agents of Washington v. Commissioner

In Professional Insurance Agents of Washington v. Commissioner, 875 F.2d 870 (9th Cir. 1989), the appeals court affirmed, in a one word opinion, the Tax Court's determination that fees received by an IRC 501(c)(6) business league comprised of independent insurance agents for promoting a malpractice insurance program was unrelated business taxable income. See Professional Insurance Agents of Washington v. Commissioner, T.C.M. 1987-68.

6. Other Developments

A. Texas Apartment Association v. United States

In Texas Apartment Association v. United States, 869 F.2d. 884 (5th Cir. 1989), the court of appeals affirmed an unreported district court decision that the sale of preprinted lease forms and a landlord's manual by a trade association of apartment owners and service companies described in IRC 501(c)(6), was substantially related to the organization's performance of its exempt function and consequently did not

result in unrelated business income. After acknowledging the parties' agreement that the sales constituted a trade or business regularly carried on, the court applied a two-step test which indicated that the sales were substantially related to the association's exempt function. First, the sales were unique to the organization's tax-exempt purposes because the trade association material was substantially different than the material of commercial counterparts, and the association's material was often used in the association's educational and legislative programs. Second, the association's activities benefited its members in their capacity as members instead of as individuals because the publications benefited the entire rental business.

B. California Thoroughbred Breeders Association v. Commissioner

In California Thoroughbred Breeders Association v. Commissioner, T.C. Memo. 1989-342, the Tax Court considered whether amounts received by an exempt agricultural organization (CTBA) from the sale of horses constituted unrelated business taxable income. CTBA, which is described in IRC 501(c)(5), entered into a joint venture agreement with a company that auctions thoroughbred horses. Pursuant to the agreement income and losses were shared equally by the exempt organization and the auction company. During the taxable years in question gross income from the sales of horses varied between $1.5 million and $3.2 million per year. CTBA earned between $200,000 and $800,000 per year.

CTBA decided whether auction sales would occur and determined the dates and places of sales. CTBA also performed a variety of services in connection with the sales, including preparing and handling facilities for sales, preparing pedigree information, printing and distributing catalogs, and handling receipts and disbursements from sales. CTBA argued that by facilitating these auction sales it encouraged the breeding of horses and furthered agricultural purposes. The Government argued that the sales had no causal relationship to the organization's exempt purposes and were conducted primarily as a commercial business.

The Tax Court emphasized that the "substantially related" test under IRC 513 depends upon the facts and circumstances in each case. The evidence presented at trial indicated that private commercial operations in the state had a history of unreliable auction sales. In the court's view, the auctions provided the breeders a local market with continuity and integrity in which to make necessary sales, and created a reputation for California horses. Therefore, the court held that the sales activities were substantially related to CTBA's exempt purposes.

In a footnote, the court declined to adopt the position taken in Rev. Rul. 69-51, 1969-1 C.B. 159, which holds that an exempt cattle association's sale of members' cattle was carried on for the convenience of members and had no causal relationship to the association's exempt purpose.

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1990 UPDATE
Editor's Note: In late 1990 the IRS updated each topic that came out in early 1990 in its Exempt Organizations Continuing Professional EducationTechnical Instruction Program textbook for 1990. As a result, what you have already read contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

F. UPDATE ON UNRELATED BUSINESS INCOME

1. Social Clubs

In Portland Golf Club v. Commissioner, 58 U.S.L.W. 4886, U.S. (1990), the Supreme Court affirmed the position of the Ninth Circuit Court of Appeals, holding that an IRC 501(c)(7) social club must conduct nonmember sales with a profit motive (i.e., with an intent to generate receipts in excess of costs) in order to offset losses against its investment income. The court also concluded that in demonstrating the requisite profit motive, a club must employ the same method of allocating fixed expenses as it uses in calculating its actual loss. The Portland Golf Club's income from sales to nonmembers of food and beverages exceeded the direct costs attributable to such sales. However, the Club consistently reported substantial tax losses from its nonmember sales that arose after it allocated a portion of certain fixed expenses such as depreciation and overhead using an allocation ratio based on gross receipts.

The court stated that the statutory scheme of taxation of social clubs was intended to achieve tax neutrality and ensure that members are not subject to tax disadvantages by pooling their resources. It was not intended to provide social clubs with a tax advantage not available to other organizations, by allowing them to deduct losses without showing the profit motive required by IRC 162. In the court's view, the deductions claimed in this case were allowable, if at all, only under IRC 162.

Noting the Club's contention that its calculation of losses rests on the claim that a portion of its fixed expense is properly regarded as attributable to the production of income from nonmember sales, the court found it contradictory to argue that the allocable fixed costs were irrelevant to the determination of the actual economic cost or profit. Accordingly, the Club was foreclosed from attempting to demonstrate its intent to profit by arguing that some other allocation method more accurately reflects economic reality. The Ninth Circuit had remanded the case to the Tax Court on this point.

Three justices disagreed with the holding on the allocation issue, but concurred in the result. They noted that given the remand, it was unnecessary for disposition of the case. They also believed the majority departed from the traditional practice of courts and the Service in determining whether an activity is conducted as a trade or business by focusing on the consistency of the accounting method used by the taxpayer rather than by considering a variety of factors characteristic of how a trade or business is conducted.

The opinion represents a complete victory for the Service, sustaining the position stated in Rev. Rul. 81-69, 1981-1 C.B. 351, and resolves the conflict between the position of the Sixth Circuit, Cleveland Athletic Club v. Commissioner, 779 F.2d 1160 (6th Cir. 1985), and that of the Second and Ninth Circuits, The Brook, Inc. v. Commissioner, 799 F.2d 833 (2nd Cir. 1986), and North Ridge Country Club v. Commissioner, 877 F.2d 750 (Ninth Cir. 1989).

2. Advertising

The Supreme Court has denied review of the circuit court's opinion in West Virginia State Medical Association v. Commissioner, 882 F. 2d 123 (4th Cir. 1989), cert. denied, 58 U.S.L.W. 3448, U.S. (1990). The U.S. Court of Appeals for the Fourth Circuit upheld the decision of the Tax Court which disallowed the deduction of medical journal advertising losses from the income of a separate unrelated business of the medical association. The courts held that the association's policy of voluntarily incurring losses on the advertising contained in its journal evidenced a lack of a profit motive and, therefore, the deduction taken by the association for losses sustained was properly disallowed. See 1990 CPE Text p. 128.

3. Insurance

American Postal Workers Union, AFL-CIO v. United States, No. 88-1091 (D.D.C. Dec. 19, 1989) concerned a labor union described in IRC 501(c)(5). The

American Postal Workers Union (APWU) was created to represent the interests of postal workers and mail handlers whether or not employed by the United States Postal Service and federal employees generally. The "associate members," one of five membership classes, are federal employees who are not employed by the United States Postal Service. The associate members were not represented by the union in collective bargaining and did not possess rights to hold office or vote. APWU sponsors the American Postal Workers Union Health Plan (the Health Plan) in order to provide health insurance benefits to its members. As a sponsor, APWU provides several services for the Health Plan such as benefit design, marketing, and claims supervision. The Plan reimburses the APWU for the cost of its services as a sponsor.

The court rejected the government's position that the portion of the service fee allocated to associate members and all associate member dues constituted unrelated business income. The government reasoned that associate members are not bona fide union members; therefore, providing health benefits to associate members does not further the APWU's exempt purposes and the union must have intended to profit both from the collection of associate member dues and from the associate member portion of the service fee.

The court concluded that associate members were bona fide APWU members because the union had the right to define its members as it wished. Whether a member could vote and what benefit was received did not determine if a person was a member. In addition, the union's sponsorship of its Health Plan was not an unrelated trade or business because it was substantially related to its exempt purposes and was not motivated by profit.

An appeal has been filed in this case.

4. Royalties

In Disabled American Veterans v. Commissioner, 94 T.C. No. 6 (February 26, 1990), the Tax Court considered whether an IRC 501(c)(4) organization's income from rentals of its donor lists constitutes royalties, excludable from the unrelated business income tax under IRC 512(b)(2).

The Disabled American Veterans (DAV) established and maintained a list of donors so that additional contributions could be solicited from prior contributors. The Service and the DAV both agreed that the donor list represented an intangible asset. To keep the donor list productive, the DAV removed stale names (names of donors

who had either died, ceased contributing, or moved without a forwarding address) and added new names on a continuous basis.

Between 1974 and 1985, the DAV, following a practice begun in 1960, "rented" the names on its donor list to both exempt and for-profit organizations for a one-time mailing. For a fee, the user organization was entitled to one use of the names, unless it received a contribution from the solicitation, in which case it was entitled to add that name to its own contributor list. In addition, the DAV exchanged the right to use names on its donor list for similar rights to use names on other organizations' mailing lists. The DAV protected against unauthorized use of its donor list by imposing certain conditions on its use, such as prior approval of all mailings, and by inserting dummy names into the list, which enabled it to monitor use of the names.

DAV and the Government previously litigated the issue of whether list rental payments received by DAV were properly classified as excludable royalties in Disabled American Veterans v. United States, 650 F.2d 1178 (Ct. Cl. 1981) ("DAV I"). That case covered taxable years 1970 through 1973. There, the Court of Claims first rejected the taxpayer's contention that the list rentals were a related trade or business, and for that reason, not includable in unrelated business taxable income. The court then addressed the taxpayer's alternative argument that the list rental receipts were excludable royalties under IRC 512(b)(2), and concluded that the royalty exclusion only encompassed passive investments and that the list rentals could not qualify, since the taxpayer was actively involved in the business of renting out its donor lists.

Two months after the decision in DAV I, the Service issued Rev. Rul. 81-178, 1981-2 C.B. 135. The issue in Rev. Rul. 81-178 was whether the taxpayer, an exempt labor organization representing professional athletes, received excludable royalties under IRC 512(b)(2) from licensing agreements authorizing businesses to use its copyrights, trademarks and other intangible assets. Unlike the Court of Claims, which considered royalties for purposes of IRC 512(b)(2) as a subcategory of passive investments, the Rev. Rul. defined royalties as payments related to the use of a valuable right without more.

The Tax Court, citing Rev. Rul. 81-178, held that the payments arising from the list rentals were excludable royalties. The court rejected the Court of Claims' holding that the exclusion for royalties was intended to exclude only passive royalties and did not apply to DAV's income since it was generated through extensive business activity. The majority stated that "any holder of a valuable intangible asset may

improve the value . . . of its asset without affecting the characterization of the payments it receives when it licenses the improved product."

The court stated that IRC 512(b)'s language is not restricted to only royalties from passive sources. Contrasting this language with other Code provisions where Congress specifically distinguished between passive royalties and those derived from the active conduct of a business, the court refused to "read a requirement into the Code that income must be derived from passive sources when Congress has not chosen to include such a requirement." The court also rejected the Government's contention that the payments were not royalties because the DAV protected against unauthorized use of its donor list.

The Tax Court distinguished three recent opinions in which it held that the royalty exclusion did not apply on the grounds that the payments in those cases were for advertising or services, not the use of intangible property. Fraternal Order of Police State Troopers Lodge No. 41 v. Commissioner, 87 T.C. 747 (1986), aff'd 833 F.2d 717 (7th Cir. 1987); National Water Well Association v. Commissioner, 92 T.C. 75 (1989); National Collegiate Athletic Association v. Commissioner, 92 T.C. 27 (1989). In the court's view these cases concerned the categorization of amounts as royalties, not the question whether amounts were "active" as opposed to "passive" royalties.

A strongly worded dissenting opinion stated that the majority "summarily rejects and misinterprets" substantial case authority holding that the exception provided in IRC 512(b) encompasses only those royalties earned from traditional sources of passive investment income. The dissent also contended that the doctrines of stare decisis and collateral estoppel required a decision in favor of the Service.

This decision has been appealed.

5. Other Developments

In Uniformed Services Benefit Association v. United States, 727 F. Supp. 533, (W.D. Mo. 1990), the court held that investment income used by an IRC 501(c)(9) organization to purchase excess building capacity, some of which remained unused after 10 years, constitutes unrelated trade or business income. The court concluded that such income was not properly "set aside for reasonable costs of administration" and, therefore, was not "exempt function income" within the meaning of IRC 512(a)(3)(B) even though the parties stipulated that the purchase was a reasonable and prudent business decision.

The court further held that the organization's purchase of excess computer capacity was a reasonable cost of administration since the excess capacity was soon to be absorbed by immediate and foreseeable growth. Thus, investment income used for this purpose did not constitute unrelated trade or business income.