IRS Letter Rulings and TAMs (1954-1997), UIL No. 170.00-00 Charitable contributions and gifts; UIL No. 511.00-00 Tax on unrelated business income of charitable, etc., organizations; UIL No. 512.01-01 Computation of tax on unrelated business taxable income, Exception,, Letter Ruling 9147007, (Aug. 16, 1991), Internal Revenue Service, (Aug. 16, 1991)

IRS Letter Rulings and TAMs (1954-1997)

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Letter Ruling 9147007, August 16, 1991

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Charitable contributions and gifts

UIL No. 0511.00-00

Tax on unrelated business income of charitable, etc., organizations

UIL No. 0512.01-01

Computation of tax on unrelated business taxable income

- Exception, additions, and limitations

-- Dual use of assets or facilities

UIL No. 0513.00-00

Unrelated trade or business

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

[Code Secs. 170 , 511 , 512 and 513]

ISSUE

Whether amounts received from a ***** by a tax exempt organization, ***** constitute unrelated business taxable income under section 512(a)(1) of the Internal Revenue Code and, thus, are subject to tax under section 511 ?

FACTS

An exempt organization, [herein “Organization”], was organized as a non-profit corporation and is recognized as exempt under section 501(a) as an organization described in section 501(c) (3) of Code for educational purposes. It is excluded from private foundation status because it is the type of organization described in section 509(a)(3) . Specifically, it ***** for a certain ***** which is also recognized as exempt under section 501(c)(3) . *****.

During the period immediately preceding the *****. The Organization also *****. These activities constitute an integral part of *****.

The Organization pays significant sums to the *****. In order to raise the required sums, the Organization engages in income generating efforts.

*****. The broker was successful in introducing the Organization to a ***** and coordinated the drafting of an agreement between the two ***** organizations. This negotiated contract, entered into in ***** represents the interests of the organization and the *****.

The contract provides that the ***** would be the *****. The contract recites the mutual receipt of valuable, good and sufficient consideration. The Organization, in part, is obligated to present *****. In return, during the ***** term of the contract, the ***** will pay the Organization a total of ***** as follows: *****.

The contract contains four relevant parts, which are entitled: *****.

The ***** part of the contract includes changing the then current ***** to a *****. Thus, the ***** consists of the distinctively presented *****. Furthermore, the ***** part prescribes that the Organization shall cause ***** to be *****. The ***** part requires that the ***** shall (a)***** and (b)*****. The ***** requires that ***** further ***** and that *****. Furthermore, the ***** has the right to *****.

In addition to the three provisions set out above, the ***** re-affirms certain other duties owed to the ***** under the ***** Agreement. The Organization shall *****.

As a result of implementing the many provisions of the ***** Agreement, the look of the ***** has changed. The ***** is now

*****. The cumulative effect of these well positioned visual images is that *****.

Additionally, under the terms of the agreement, *****. As a matter of practice, the chief executive officer of the *****.

Concerning the years at issue, the Organization has conducted at least ***** under the ***** Agreement. The Form 990 for that taxable year treated the amounts paid under the ***** Agreement as part of its program service revenue. The organization reported no contributions, gifts, grants or similar amounts.

APPLICABLE LAW

Section 511(a) of the Code provides for the taxation of unrelated business taxable income of organizations described in section 501(c) .

Section 512(a)(1) of the Code provides, in part, that the term “unrelated business taxable income” means the gross income derived from any “unrelated trade or business” (as defined in section 513) regularly carried on by it, less certain deductions, and computed with the modifications provided in section 512(b) .

Section 512(b)(2) of the Code provides for the exclusion from the computation of unrelated business taxable income of royalties, and all deductions directly connected with such income.

Section 513(a) of the Code provides, in part, that the term “unrelated trade or business” means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501 .

Section 170(a)(1) of the Code provides for the deductibility of any charitable contribution (as that term is defined in section 170(c)). Section 170(c) defines the term “charitable contribution” as a contribution or gift to or for the use of certain specified donee organizations.

Section 1.513-1(a) of the Income Tax Regulations provides that unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includable in the computation of unrelated business taxable income if: (1) it is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization’s performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that in general, any activity of a section 511 organization that is carried on for the production of income and which otherwise possesses the characteristics required to constitute a “trade or business” within the meaning of section 162 - and which, in addition is not substantially related to the

performance of exempt functions - may be an unrelated trade or business within the meaning of section 513 of the Code.

Section 1.513-1(c)(2) (ii) of the regulations provides that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations. In general, 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 and promotional efforts typical of commercial endeavors. On the other hand, where a non-qualifying activity is not merely casual, but is systematically and consistently promoted and carried on by the organization, then such activity meets the section 512 requirement of regularity.

In United States v. American College of Physicians, 457 U.S. 834 (1986), the Court considered the question of whether advertising was substantially related to an exempt organization's exempt function. In that case, the Court held that advertising was not substantially related unless the advertisements contributed importantly to the exempt organization's exempt functions.

In United States v. American Bar Endowment, 477 U.S. 105 (1986), the Court considered whether income that a tax exempt charitable organization derived from offering group insurance to its members constituted unrelated business taxable income. The Court held that the organization was conducting a trade or business within the meaning of section 513(c) of the Code and section 1.513-1(b) of the regulations, where the American Bar Endowment provided goods or services in a manner characteristic of a trade or business under section 162 of the Code. Under this provision, the standard test for the existence of a trade or business is whether the activity was entered into with the dominant hope and intent of realizing a profit.

In Hernandez v. Commissioner, 490 U.S. 680 (1989), the Court questioned whether payments in return for sessions of religious services were deductible as charitable contributions under section 170(a) of the Code. The Court rejected the petitioner's argument that deductibility turned on the nature of the benefit to the payor; the petitioners claimed they received nothing more than a benefit that was religious in nature. Using a structural analysis, the Court disagreed and held that the payments were part of a "quintessential quid pro quo exchange." Accordingly, the Court held the payments were not gifts or contributions.

In Carolinas Farm & Power Equipment Dealers Association, Inc. v. Commissioner, 699 F.2d 167 (4th Cir. 1983), the court held that a taxpayer was conducting a "trade or business" where the taxpayer acted with a profit motive and the activity was not substantially related to a charitable end.

National Collegiate Athletic Association v. Commissioner, 914 F.2d 1417 (10th Cir. 1990), action on decision, 1991-015 (July 3, 1991) (nonacq.), held that revenue received from program advertising did not constitute unrelated trade or business income where the advertising occurred solely during a four day period of the entire year. In rejecting the Service's argument, the Tenth Circuit held that in determining whether an activity was regularly carried on, the relevant period under inquiry was the period when the activity of advertising itself occurred. The Service does not follow this decision.

A payment to a charity (or qualified donee) is a "contribution or gift" for purposes of section 170(c) of the Code if it is made without an expectation of a return benefit commensurate with the amount of the payment. Hernandez, supra. The Service recognizes that a charitable organization membership privilege of being associated with or being known as a benefactor of the charity is not a significant return benefit and, thus, does not cause membership dues to be nondeductible under section 170 . See Rev. Rul. 68-432 , 1968-2 C.B. 104, where the additional cost of Sustaining and Fellowship memberships in a museum was deductible under section 170 because the only additional privilege of such memberships was being associated with or being known as a benefactor of the museum. Conversely, a payment made with an expectation of a substantial return benefit will be presumed by the Service not to be a contribution or gift.

Limited recognition of a donor's generosity as an insubstantial return benefit has been acknowledged by the Service in contexts other than section 170 of the Code. For example, Rev. Rul. 67-342, 1967-2 C.B. 187, concluded that an exempt educational organization that disseminated its educational material by means of

commercial television did not commercially exploit its exempt purpose by acknowledging the sponsors of its programs with a statement to the effect that the programs had been paid for as a public service by the sponsors. Similarly, Rev. Rul. 77-367 , 1977-2 C.B. 193, found that an organization that operated a replica of a historical village did operate for exclusively exempt purposes despite the benefits to a corporate donor of having the village named after it, having its name mentioned in the organization's publications, and having its name associated with the village in the corporation's own advertising. Section 1.509(a)-3(f)(3) of the Income Tax Regulations provides an example of donor identification at an award ceremony as not defeating a contribution for purposes of section 509(a)(2)(A)(i) of the Code. The example describes the recognition as incidental to the making of the awards encouraging worthy youngsters in their pursuit of farming and livestock raising. Similarly, section 53.4941(d)-2(f)(2) of the Foundation and Similar Excise Taxes Regulations acknowledges the theoretical possibility of donor recognition as insubstantial for purposes of determining an act of self-dealing under section 4941 of the Code. Section 53 .4941(d)-2(f)(4) Example (4) provides that "by itself" an agreement by the donee as a condition of the gift to name a recreation center after a donor will not amount to an act of self-dealing.[4]

In Rev. Rul. 73-424 , 1973-2 C.B. 190, an organization distributed to members a "yearbook" containing editorial materials and advertising. A commercial publisher, under contract to the organization, solicited advertising sales for approximately three months, collected from advertisers and printed the yearbook. The ruling reasoned that the advertising business was regularly carried on because by engaging in extensive campaigning of advertising solicitation, the organization was conducting competitive and promotional efforts typical of commercial endeavors. Thus, the activities manifested a frequency and continuity and were pursued in a manner not materially different from similar commercial activities.

Rev. Rul. 75-201 , 1975-1 C.B. 164, held that the solicitation, by volunteers, of advertisements for an annual concert book, which was distributed at an orchestra's annual charity ball, was an intermittent activity. The cost of the advertisements was substantially higher than the market rate for otherwise similar advertisements. The ruling expressly stated that the concert book was an integral part of the annual fund-raising event as defined in section 1.513-1(c)(2) (iii).

Rev. Rul. 81-178 , 1981-2 C.B. 135 (situation 1), considered certain payments to an exempt labor organization from various business enterprises for the use of the organization's trademark and similar properties. The Service ruled the payments were gross income from an unrelated trade or business. However, because they related to the use of a valuable right, they were royalties that were excluded from the computation of unrelated business taxable income under section 512(b)(2) of the Code. In situation 2 of this revenue ruling, the additional fact that the agreements required the personal services of the organization's members in connection with the endorsed products and services caused the payments to be characterized as compensation for personal services. The payments in situation 2 were not royalties and, thus, were not excepted from the definition of unrelated business income.

ANALYSIS

American Bar Endowment, supra, at 110, stated that the conduct of a "trade or business" is the provision of goods or services with the dominant hope and intent of realizing a profit. By providing valuable services, ***** in return for a large payment, the Organization is engaged in an activity for the production of income from the provision of services.

The Organization argues that the ***** payment is a gift or contribution that was made with no expectation of a return in the way of goods or services. The Organization also argues that the donative intent or lack thereof on the part of ***** is not determinative of the treatment to be accorded the payments by the Organization. Accordingly, we agree with the Organization that regardless of the subjective intent of ***** which we do not know, and regardless of how ***** treated the payment on its federal income tax return, which we also do not know, the question to be resolved here is whether the payment was in exchange for goods and/or services provided by the Organization. In other words, did the Organization provide a quid pro quo in exchange for the payment from *****.

The appropriate way to answer this question is to look at all the facts and circumstances to see if the payment was made with an expectation of receiving from the Organization a substantial return benefit. As described above, the Service has provided in several contexts that recognition of a donor's generosity can be an insubstantial return benefit. In this case, however, we believe that what the Organization has provided to ***** amounts to much more than mere recognition of ***** generosity. Indeed, we believe it amounts to a substantial return benefit.

The following commitments in the agreement between the Organization and ***** clearly show that in return for ***** payment the Organization will provide a substantial quid pro quo. The Organization agreed to:

*****.

The Organization argues that its provision of these benefits is closer to an instance of mere recognition of a donor's generosity than an instance of a substantial return benefit to *****. In essence, the Organization argues that the ***** does not cause the investment of an additionally significant amount of time, effort, or expense for the Organization in that ***** will be used in much the same way as it has always been used.

Our view is that the agreement clearly shows that the ***** payment is commensurate in value with the benefits the ***** expects to receive from the Organization. In other words, we believe that the relative ease, as a practical matter, for the Organization to ***** does not overcome the fact that providing such a benefit along with all the other benefits provided to ***** amounts to a very valuable package of benefits. Finally, we do not find the fact that the Organization has not obligated itself to ***** payments. In any event, the *****. We find that the Organization has provided a substantial return benefit to ***** in exchange for the ***** payment. We believe that the benefits provided in this case are significantly different from the types of donor recognition previously recognized by the Service as insignificant.

The Organization has argued that section 511 of the Code imposes a tax on unrelated business income only where there is a finding of unfair competition. In the Service's view, there is no necessity to determine that the Organization actually competes with other advertisers. See Carolinas Farm & Power Equipment Dealers Association, Inc. v. Commissioner, supra. Although the notion of unfair competition is the underlying reason for the enactment of the tax on unrelated business income, there is no requirement that unfair competition be present in order to tax the proceeds from an activity. Section 1.513-1(b) of the regulations. The Service maintains that the presence of unfair competition is neither the sole nor the primary criterion to be considered in determining whether an activity is an unrelated trade or business. However, even if it were true that there must be a finding of unfair competition, it is important to recognize the broad reach of the term "unfair competition." For-profit entities that offer ***** and other services might find it is difficult to compete for the business of the ***** which might otherwise be inclined to purchase the services of these for-profit entities. Using this line of reasoning, the United States Supreme Court concluded that the American Bar Endowment was in competition with other insurance concerns; similarly, the Organization is in competition with other entities, *****Carolinas Farm & Power Equipment Dealers Association, Inc. v. Commissioner indicates that where an organization (1) conducts an activity with a profit motive and (2) the activity is not substantially related to that organization's exempt purpose, then the organization's activity presents a sufficient likelihood of competition to be within the policy of the statute. Section 1.513-1(b) of the regulations. Profit is merely the gross proceeds of a transaction less the cost of the transaction. The Organization generates more in proceeds from the questioned ***** Agreement than it expends in providing services to *****. Thus, ***** the Organization generated ***** in providing miscellaneous services to the *****.

The Organization's activities are not substantially related to its exempt function. Neither the addition of the ***** nor the displaying of ***** contributes importantly to the Organization's educational purpose. That the Organization receives money from ***** is irrelevant to this analysis, in accordance with section 513(a) of the Code. See also, American College of Physicians, supra.

Another question to be addressed is whether the income producing activity is "regularly carried on." This determination should not be based merely on the *****. Rather, it is necessary to consider the normal time span for the trade or business, together with whether the activity is carried on in a manner comparable to that of a

non-exempt organization. The reason is clear. The term “activity” in connection with “trade or business” must necessarily denote an otherwise commercial undertaking and the full set of business operations undertaken by a particular person that constitute a separate source of income production.[5] A fair review of the available information indicates that pursuant to the ***** Agreement the Organization provides services to the ***** over a relatively significant period of time. These services are provided following the *****. In our view, the income generating activity is not of a short or infrequent duration, given the nature of *****. In fact, the activity is systematic and consistent. Furthermore, the Organization’s services are provided in a manner consistent with competitive and promotional efforts typical of commercial endeavors. See, section 1.513-1(c)(2) (ii) of the regulations; compare Rev. Rul. 73-424 , supra, with Rev. Rul. 75-201 , supra.

This “regularly carried on” analysis reflects the correct interpretation of that term. Accordingly, we are in disagreement with the Tenth Circuit’s National Collegiate Athletic Association decision. In our view the court’s factual analysis is faulty and its legal conclusions erroneous. As stated earlier, the Service will not follow this decision. Additionally, we believe this case is factually distinguishable from the situation considered in National Collegiate Athletic Association v. Commissioner, supra.

A royalty is a payment for the use of a valuable right. The Organization provides various services, *****. The Organization has the duty to *****. It is the Organization that will obtain the *****. The Organization is contractually required to *****. Additionally, the Organization is contractually required to insure the ***** on the *****. Thus, any argument that the ***** payments are royalties is misconceived. The ***** is not paying for the use of a valuable right; it is the Organization that is required to ***** Cf. Fraternal Order Of Police, Illinois State Troopers, Lodge 41 v. Commissioner, 833 F.2d 717, 723-24 (7th Cir. 1987) (exempt organization actively involved in the production of the income); National Water Well Association, Inc. v. Commissioner, 92 T.C. 75, 99-101 (1989) (same effect); National Collegiate Athletic Association v. Commissioner, 92 T.C. 456, 468-70 (1989) (same effect), rev’d on other grounds, National Collegiate Athletic Association, supra; National Collegiate Athletic Association v. Commissioner, A.O.D. 1991-015 (July 3, 1991).

The Organization asserts that it would do these things without regard to the ***** Agreement. This is not correct. It is probably true that the Organization has a duty to *****. However, the Organization was under no duty to ***** until the Organization entered into the ***** Agreement. In fact, ***** Agreement, *****. This ***** termination provision suggests that ***** is a significant addition to an existing duty. Accordingly, the arrangement between the Organization and ***** is analogous to the arrangement in Rev. Rul. 81-178 (situation 2), and the payments are not royalties that are excluded from the computation of unrelated business taxable income under section 512(b)(2) .

CONCLUSION

The amounts received from a ***** by an exempt organization, which ***** in exchange for certain services provided by the organization to ***** constitute unrelated business taxable income under ***** section 512(a)(1) of the Code and, thus, are subject to tax under section 511 .

A copy of the technical advice memorandum is to be given to the organization. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

[4] *****.

[5] *****. It is illogical to assume these activities were conducted for no purpose or for an unlikely purpose.