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Nuts and Bolts of Unrelated Business Income Tax

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I. Introduction. This paper summarizes the unrelated business income tax rules as they apply to tax-exempt charitable organizations described in Section 501(c)(3) of the Code.¹ Since the 1950s, the unrelated business income tax has been imposed on a charity’s net income from a regularly carried on trade or business that is unrelated to the charity’s tax-exempt purposes. Often times, the justification for imposing this tax on a charity’s net income from unrelated business activities is that such activities involve unfair competition with the charity’s for-profit counterparts.²

II. Unrelated Business Income Tax (“UBIT”): General Rules.³

A. Definition of Unrelated Business. Organizations described in Section 501(c)(3) of the Code are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.⁴ The term “unrelated trade or business” means an activity conducted by a tax-exempt organization which is regularly carried on⁵ for the production of income from the sale of goods or performance of services⁶ and which is not substantially related to the performance of the organization’s charitable, educational or other exempt functions.⁷

1. Activity is a “Trade or Business.” For purposes of the unrelated business income tax regime, “the term ‘trade or business’ has the same meaning 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.”⁸ Section 162 of the Code governs the deductibility of trade or business expenses. In that context, the U.S. Supreme Court has declared that “to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”⁹ When applying this test, the IRS may take into account a key purpose of the unrelated business income tax: to prevent unfair competition between taxable and tax-exempt entities. “[W]here an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in

¹ All references to the “Code” are to the Internal Revenue Code of 1986, as amended.
² See Treas. Reg. § 1.513-1(b) (“The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”).
³ Portions of this discussion on unrelated business income are extracted from the author’s previously published article, The Taxation of Cause-Related Marketing, 85 CHI-KENT L. REV. 883 (2010).
⁴ See I.R.C. § 511.
⁵ Treas. Reg. § 1.513-1(a).
⁶ I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).
⁷ I.R.C. § 513(a).
⁸ Treas. Reg. § 1.513-1(b).
competition with taxable organizations.” However, the mere fact that the activity is conducted as a fund-raising activity of the charity is not sufficient to conclude that the activity is not a trade or business.

The most important element as to whether the activity is a trade or business is the presence of a profit motive. In the context of a tax-exempt organization, the U.S. Supreme Court declared that the inquiry should be whether the activity “was entered into with the dominant hope and intent of realizing a profit.” Significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises. When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive. An activity that produces consistent losses may indicate that no profit motive exists, and therefore the activity is not a trade or business. This determination may prevent an exempt organization from offsetting UBTI from profitable activities with losses from a consistently unprofitable activity.

2. Regularly Carried On Requirement. In general, in determining whether a trade or business is “regularly carried on,” one must consider the frequency and continuity with which the activities productive of income are conducted, and the manner in which they are pursued. Business activities are deemed to be “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.” For example, “[w]here income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business [sic].” Similarly, “income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically.” However, “[w]here income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business.”

10 Treas. Reg. § 1.513-1(b). *But see* La. Credit Union League v. United States, 693 F.2d 525, 542 (5th Cir. 1982) (“*T*he presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to be taxed.”).
11 *See Am. Bar Endowment, 477 U.S. at 115* (stating that a charity cannot escape taxation by characterizing an activity as fund raising, because otherwise “any exempt organization could engage in a tax-free business by ‘giving away’ its product in return for a ‘contribution’ equal to the market value of the product.”).
13 See, e.g., Carolinas Farm & Power Equip. Dealers Ass’n, Inc. v. United States, 699 F.2d 167, 170 (4th Cir. 1983) (“*T*here is no better objective measure of an organization’s motive for conducting an activity than the ends it achieves.”); La. Credit Union League v. United States, 693 F.2d 525, 533 (5th Cir. 1982) (finding that a profit motive existed based on the fact that the organization was extensively involved in endorsing and administering an insurance program that proved highly profitable); Fraternal Order of Police Ill. State Troopers Lodge No. 41 v. Comm’r, 87 T.C. 747, 756 (1986), aff’d, 833 F.2d 717 (7th Cir. 1987) (reasoning that the organization’s advertising activities were “obviously conducted with a profit motive” because the activities were highly lucrative and with no risk or expense to the organization).
14 Treas. Reg. § 1.513-1(c)(1).
15 Treas. Reg. § 1.513-1(c)(2)(i).
16 Treas. Reg. § 1.513-1(c)(2)(ii).
17 Treas. Reg. § 1.513-1(c)(2)(iii).
18 Treas. Reg. § 1.513-1(c)(2)(i).
In making this determination, it is essential to identify the appropriate nonexempt commercial counterpart to the exempt organization’s activity, because the manner in which the nonexempt commercial counterpart conducts its similar activities has an important bearing on whether the activity is considered to be carried on year-round, on a seasonal basis or intermittently. For example, a tax-exempt organization’s annual Christmas card sales program was determined to be regularly carried on when conducted over several months during the holiday season because, although nonexempt organizations normally conduct the sale of greeting cards year-round, the Christmas card portion of the nonexempt organizations’ sales was conducted over the same seasonal period.\footnote{Veterans of Foreign Wars, Dept. of Mich. v. Comm'r, 89 T.C. 7, 32-37 (1987).} By contrast, when an exempt organization’s fundraising activities are conducted on an intermittent basis, such activities are generally considered not to be regularly carried on.\footnote{See Treas. Reg. § 1.513-1(c)(2)(iii) (stating fundraising activities lasting only a short period of time will generally not be regarded as regularly carried on, despite their recurrence or their manner of conduct); Suffolk County Patrolmen’s Benevolent Ass’n, Inc. v. Comm’r, 77 T.C. 1314 (1981), acq., 1984-2 C.B. 2 (determining that the conduct of an annual vaudeville show one weekend per year and the solicitation and publication of advertising in the related program guide which lasted eight to sixteen weeks per year was intermittent and not regularly carried on). Cf. Treas. Reg. § 1.513-1(c)(2)(ii) (“[E]xempt 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.”)}

If an exempt organization’s engages in business activities intermittently, such activities will not be considered regularly carried when such activities are conducted without the competitive and promotional efforts of commercial endeavors. For example, the sale of candy bars at a university bookstore are not treated as regularly carried on under this casual sale exception even though conducted year round because the sale is incidental to the sale of textbooks and other educational supplies to students.\footnote{See Treas. Reg. § 1.513-1(c)(2)(ii)}

Furthermore, in determining whether an exempt organization’s business activities are “regularly carried on,” the activities of the organization’s agents may be taken into account.\footnote{State Police Ass’n of Mass. v. Comm’r, 72 T.C.M. (CCH) 582 (1996), aff’d, 125 F.3d 1 (1st Cir. 1997).} Courts disagree as to whether an exempt organization’s preparation time in organizing and developing an income-producing activity may be taken into account.\footnote{See Nat’l Collegiate Athletic Ass’n v. Comm’r, 92 T.C. 456 (1989) (finding that NCAA’s sale of advertisements for annual championship program was “regularly carried on,” in part because of the amount of preliminary time spent to solicit advertisements and prepare them for publication), rev’d, 914 F.2d 1417 (10th Cir. 1990) (holding that this activity was not regularly carried on, because only the time spent conducting the activity, not the time spent in preparations, is relevant to that determination); A.O.D. 1991-015 (indicating that the IRS will continue to litigate the issue).} This in an inherently factual determination. To determine whether the business activity is “related,” the relationship between the conduct of the business activities that generate the income and the accomplishment of the organization’s exempt purposes must be examined to determine whether a causal relationship exists.\footnote{See Treas. Reg. § 1.513-1(d)(1).} The activity will not be substantially related merely because the
income produced from the activity is used to further the organization’s exempt purposes. Rather, the inquiry focuses on the manner in which the income is earned. Thus, a substantial causal relationship exists if the distribution of the goods from which the income is derived contributes importantly to the accomplishment of the organization’s exempt purposes. In each case, the determination of whether this relationship exists depends on the facts and circumstances involved.

In making this determination, the scale and scope of the activities involved are considered in relation to the nature and extent of the exempt functions they are serving. If the activities are conducted on a scale larger than is reasonably necessary to accomplish the exempt purposes, the income attributed to the excess activities constitutes unrelated business income. Additionally, the sale of a product resulting from the performance of an exempt function will not produce UBTI to the extent it is sold in substantially the same state as it was on completion of the exempt function. But, if the product is exploited beyond that reasonably necessary to sell it upon completion of the exempt function, the income from the sale would be UBTI. For example, assume an exempt charitable organization operated for scientific purposes sells milk and cream from an experimental dairy herd. Since this is a sale of the byproduct of the organization’s exempt activity, it does not create UBTI. However, if the organization were to use the milk and cream to manufacture ice cream, pastries and other food items, the gross income from the sale of such products would be UBTI unless the manufacturing activities themselves contribute importantly to the accomplishment of the exempt purpose of the organization.

Moreover, if an exempt organization creates goodwill or another intangible that is capable of being exploited in a commercial manner, the exempt organization still must complete the UBTI analysis. Just because the intellectual property was created via an exempt activity does not make any income from its exploitation exempt. For example, a university sponsors professional orchestras on its campus during the school year. Both students and members of the general public may purchase tickets from the university. Although the presentation for the performance makes use of an intangible generated by the university’s exempt educational functions, i.e., the presence of the student body and faculty, the presentation of such music event contributes importantly to the overall educational and cultural function of the university. However, when an exempt scientific organization endorses laboratory equipment in return for money, the income derived for the sale of endorsements is UBTI.

Under the fragmentation rule, a business activity still may be considered an unrelated trade or business even though it is carried on within the broader scope of similar activities that are

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26 I.R.C. § 513(a); Treas. Reg. § 1.513-1(d)(1).
27 Treas. Reg. § 1.513-1(d)(2).
28 See I.R.C. § 511.
29 Id.
31 Id.
32 Id.
34 Id. at Ex. 2.
35 Id. at Ex. 1.
related to the organization’s exempt purpose.\textsuperscript{36} For example, pharmaceutical sales by a hospital to non-patients does not fail to constitute a trade or business merely because the hospital also sells drugs to its patients. Similarly, sales by a museum gift shop are evaluated on an item by item basis to determine if the sale of each item contributes importantly to the museum’s exempt purpose. Accordingly, sales of reprints of art displayed in the museum would relate to the museum’s exempt purpose, but sales of logo t-shirts by the museum gift shop would not.

Even if an asset is used primarily in furtherance of an organization’s exempt purpose, it may still generate UBTI if its use is not substantially related to exempt purpose.\textsuperscript{37} For example, a museum does not have UBTI when it operates a theatre during regular museum hours and shows artistic and educational films. However, if the museum operates the theatre as an ordinary motion picture theatre with mainstream Hollywood movies for public entertainment during evening hours when the museum is closed, gross income from the motion picture ticket sales would be from the conduct of an unrelated trade or business.\textsuperscript{38}

II. Exceptions and Modifications.

A. Statutory Exceptions. The term “unrelated trade or business” is subject to several exceptions under which certain businesses that may otherwise constitute unrelated businesses are removed from the scope of the tax. In particular, the term “unrelated trade or business” does not include a trade or business in which substantially all the work in carrying on the trade or business is performed for an organization without compensation.\textsuperscript{39} Unlike the other exceptions, the “volunteer exception” is not restricted as to the nature of the businesses to which it pertains. Also, an activity by an exempt organization which is carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees is excluded from the term “unrelated trade or business.”\textsuperscript{40} In addition, the term “unrelated trade or business” does not include the trade or business of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.\textsuperscript{41} Finally, an exception from the unrelated business income tax is also provided for income derived from the distribution of low cost articles incident to the solicitation of charitable contributions.\textsuperscript{42}

B. Modifications for Passive Activities Generally. The purpose of the unrelated business income tax is to eliminate the conduct of unrelated businesses by tax exempt organizations as a source of unfair competition with for-profit companies. To the extent that income of a tax exempt organization is derived from investment and other passive activities, the taxation of such income is not necessary to accomplish this goal. Accordingly, the modifications to the unrelated business income tax exclude most passive income, as well as the deductions associated with such

\textsuperscript{36} I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).
\textsuperscript{37} Treas. Reg. § 1.513-1(d)(4)(iii).
\textsuperscript{38} Id.
\textsuperscript{39} I.R.C. § 513(a)(1).
\textsuperscript{40} I.R.C. § 513(a)(2).
\textsuperscript{41} I.R.C. § 513(a)(3).
\textsuperscript{42} I.R.C. § 513(h). For tax years beginning in 2015, a low-cost article is one which has a cost to the organization of $10.50 or less. Rev. Proc. 2014-16. There are several other exceptions including, but not limited, certain entertainment activities, trade shows, hospital cooperative services and bingo games. See I.R.C. §§ 513(d)(1), (2), (3); § 513(e); § 513(f).
passive income, from the scope of the tax. In particular, the following types of passive income are excluded from unrelated business taxable income:

i. dividends;  
ii. interest;  
iii. annuities;  
iv. payments with respect to securities loans;  
v. amounts received or accrued as consideration for entering into agreements to make loans;  
vi. royalties;  
vii. gains or losses from the sale, exchange, or other disposition of property other than inventory; and  
viii. gains or losses recognized in connection with a charitable organization’s investment activities from the lapse or termination of options to buy or sell securities or real property.

1. Rents. In addition, certain rents are excluded from unrelated business taxable income. The exclusion applies to rents from real property and rents from personal property leased with such real property, provided that the rents attributable to the personal property are an incidental amount of the total rents received or accrued under the lease. Three principal exceptions limit the ability of a charitable organization to exclude the eligible rents described above from unrelated business taxable income. The exceptions apply when there are excessive personal property rents, when rent is determined by net profits from the property, and when certain services are rendered to the lessee. Under the first exception, the rental exclusion does not apply if more than 50% of the total rent received or accrued under the lease is attributable to personal property, determined at the time the personal property is first placed in service. Under the second exception, the rental exclusion is not available if the determination of the amount of rent depends in whole or in part on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage or percentages of receipts or sales. Under the third exception, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant do not constitute rent from real property. As a

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43 See generally Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).
44 I.R.C. § 512(b)(1).
45 I.R.C. § 512(b)(1).
46 I.R.C. § 512(b)(1).
47 I.R.C. § 512(b)(1). The term “payments with respect to securities loans,” refers to income derived from a securities lending transaction in which an exempt organization loans securities from its portfolio to a broker in exchange for collateral. I.R.C. § 512(a)(5). Payments derived from a securities lending transaction typically include interest earned on the collateral and dividends or interest paid on the loaned securities while in the possession of the broker.
48 I.R.C. § 512(b)(1).
49 I.R.C. § 512(b)(2). A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name or copyright. Rev. Rul. 81-178, 1981-2 C.B. 135. By contrast, the payment for personal services does not constitute a royalty. Id.
50 I.R.C. § 512(b)(5).
51 I.R.C. § 512(b)(5).
52 I.R.C. § 512(b)(3).
56 Treas. Reg. § 1.512(b)-1(c)(5).
general rule, services are considered to be rendered to the occupant if the services are (a) primarily for the convenience of the occupant, and (2) other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. 57

2. Royalties. Because royalties are passive in nature, the receipt of royalty income by a tax-exempt organization does not result in unfair competition with taxable entities. 58 Accordingly, section 512 of the Code provides that a charity’s UBTI generally does not include royalties. 59 A royalty is defined as a payment that relates to the use of a valuable right, such as a name, trademark, trade name, or copyright. 60 The royalty may be in the form of a fixed fee or a percentage of sales of the products bearing the charity’s name and logo. In addition, the tax-exempt organization may retain the right to approve the use of its name or logo without changing the determination that the income from the transaction is a royalty.

Of particular importance in the royalty context is the amount of services the charity performs in exchange for the payment received. In order to maintain the royalty exemption for the payments received, the charity may not perform more than de minimis services in connection with the arrangement. 61 If the charity performs more than insubstantial services, then the income received is considered compensation for personal services, the royalty exception would not apply, and the income would most likely be subject to tax as UBTI. 62

For example, the Internal Revenue Service privately ruled that royalties received by a charity from the license of the charity’s intellectual property to a for-profit company for use in the company’s commercial activities were excluded from the charity’s UBTI under the royalty exception. 63 Under the license agreement, the charity retained the right to review the designs and proposed uses of the charity’s intellectual property, inspect the commercial counterpart’s facilities where the product was manufactured, and inspect the commercial counterpart’s books and records annually. The Internal Revenue Service determined that these services performed by the charity in connection with the licensing arrangement were de minimis. Moreover, the licensing agreement was narrowly tailored to protect the charity’s ownership of its intellectual property by giving the charity absolute discretion to reject proposed uses of the property, providing notice on every unit displaying the charity’s mark that it was used with the charity’s permission, and allowing the charity to approve and limit mass media advertising of the product. The Internal Revenue Service concluded that the income that the charity would receive from the arrangement was “vastly out of proportion with the time and effort” the charity would expend. Therefore, it could only be compensation for the use of the charity’s intellectual property.

The determination of the permissible amount of “insubstantial services” is uncertain, however, especially in connection with the charitable organization’s exercise of quality control over the use of its name, logo, and trademarks. As is prudent business practice, a charity would want to maintain quality control over the use of its name, logo, and trademark by the corporate partner under the licensing agreement. In some cases, the Internal Revenue Service has

57 Id.
58 See Sierra Club Inc. v. Comm’r, 86 F.3d 1526, 1533 (9th Cir. 1996).
59 I.R.C. § 512(b)(2); Treas. Reg. § 1.512(b)-1(b). A charity’s UBTI would include royalties derived from debt-financed property. Treas. Reg. § 1.512(b)-1(b).
61 Sierra Club, 86 F.3d at 1533-35.
determined that “mere” quality control does not constitute more than insubstantial services related to the royalty income.\textsuperscript{64} In other cases, a charity’s “quality control” was recharacterized as services, resulting in the income from the arrangement being taxed as compensation from services rather than exempted as royalty income.\textsuperscript{65} Therefore, charities are left to struggle with the determination of the permissible types of “quality control” they can include in their licensing agreements without crossing the boundary between \textit{de minimis} and substantial services.

Furthermore, caution should be taken in relying on the royalty exception for income received from the licensing of a charity’s name or logo for placement on a corporate sponsor’s product. In evaluating the justification for the continued tax exemption for college athletic programs, the Congressional Budget Office recommended repealing the royalty exception to the extent that it applies to the licensing of a charity’s name or logo:

Some types of royalty income may reasonably be considered more commercial than others.\ldots \textit{[W]hen colleges and universities license team names, mottoes, and other trademarks to for-profit businesses that supply apparel, accessories, and credit cards to the general public, they approve each product and use of their symbols and, in some cases, exchange information, such as donor lists, with the licensees to aid in their marketing.\ldots } The manufacture or sale of such items would clearly be commercial—\ldots subject to the UBIT—\ldots if undertaken directly by the schools. Schools’ active involvement in generating licensing income could be the basis for considering such income as commercial and therefore subject to the UBIT.\ldots 

Bringing royalty income that accrues only to athletic departments under the UBIT would be problematic, however.\ldots \textit{[I]f royalty income from licensing team names to for-profit businesses was truly considered commercial and subject to the UBIT, the same arguments would apply in full force to licensing all other university names and trademarks. A consistent policy would subject all such income to the UBIT because of its commercial nature. Such a change in policy could affect many other nonprofits in addition to colleges and universities.\ldots }\textsuperscript{66}

\section*{C. Corporate Sponsorships}

Under section 513(i) of the Internal Revenue Code, the receipt of qualified sponsorship payments by a charity does not constitute the receipt of income from an unrelated trade or business, and instead, the payment is treated as a charitable contribution to the charity.\textsuperscript{67} A “qualified sponsorship payment” is “any payment\textsuperscript{68} by any person engaged in a trade or business with respect to which there is no arrangement or expectation that


\textsuperscript{65} \textit{See, e.g.}, NCAA v. Comm’r, 92 T.C. 456, 468–70 (1989), \textit{rev’d on other grounds}, 914 F.2d 1417 (10th Cir. 1990); Fraternal Order of Police v. Comm’r, 87 T.C. 747, 758 (1986), \textit{aff’d}, 833 F.2d 717 (7th Cir. 1987).

\textsuperscript{66} \textit{CONG. BUDGET OFFICE, PUB. NO. 3005, TAX PREFERENCES FOR COLLEGIATE SPORTS 13} (2009).

\textsuperscript{67} I.R.C. § 513(i); Treas. Reg. § 1.513-4(a). The Treasury Regulations provide the following example of a qualified sponsorship payment:

\begin{quote}
M, a local charity, organizes a marathon and walkathon at which it serves to participants drinks and other refreshments provided free of charge by a national corporation. The corporation also gives M prizes to be awarded to the winners of the event. M recognizes the assistance of the corporation by listing the corporation’s name in promotional fliers, in newspaper advertisements of the event and on T-shirts worn by participants. M changes the name of its event to include the name of the corporation. M’s activities constitute acknowledgement of the sponsorship.
\end{quote}

\textit{Id.} \textsuperscript{68} § 1.513-4(f), example 1.

\textsuperscript{68} “Payment” means “the payment of money, transfer of property, or performance of services.” \textit{Id.} \textsuperscript{69} § 1.513-4(c)(1).
A “substantial return benefit” is any benefit other than a “use or acknowledgement”70 of the corporate sponsor and certain disregarded benefits.71 Substantial benefits include the charitable organization’s provision of facilities, services, or other privileges to the sponsor; exclusive provider relationships;72 and any license to use intangible assets of the charitable organization.73 “If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment.”74 The exempt organization has the burden of establishing the fair market value of the substantial return benefit. If the organization fails to do so, “no portion of the payment constitutes a qualified sponsorship payment.”75

The following examples from the Treasury Regulations illustrate the application of the substantial return benefit rule.

N, an art museum, organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. N recognizes the corporation’s support by using the corporate name and established logo in materials publicizing the exhibition, which includes banners, posters, brochures and public service announcements. N also hosts a dinner for the corporation’s executives. The fair market value of the dinner exceeds 2% of the total payment. N’s use of the corporate name and logo in connection with the exhibition constitutes acknowledgement of the sponsorship. However, because the fair market value of the dinner exceeds 2% of the total payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that N can demonstrate exceeds the fair market value of the dinner is a qualified sponsorship payment.76

X, a health-based charity, sponsors a year-long initiative to educate the public about a particular medical condition. A large pharmaceutical company manufactures a drug that is used in treating the medical condition, and provides funding for the initiative that helps X produce educational materials for distribution and post information on X’s website. X’s website contains...

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69 Id. For purposes of these rules, it is irrelevant whether the sponsored activity is temporary or permanent. Id.
70 The permitted “uses or acknowledgements” under the qualified sponsorship payment rules include (i) “logos and slogans that do not contain qualitative or comparative descriptions of the payor’s products, services, facilities or company,” (ii) “a list of the payor’s locations, telephone numbers, or Internet address,” (iii) “value-neutral descriptions, including displays or visual depictions, of the payor’s product-line or services,” and (iv) “the payor’s brand or trade names and product or service listings.” Id. § 1.513-4(c)(1)(iv). “Logos or slogans that are an established part of the payor’s identity are not considered to contain qualitative or comparative descriptions.” Id.
71 Id. § 1.513-4(c)(2). A benefit is disregarded if “the aggregate fair market value of all the benefits provided to the payor or persons designated by the payor in connection with the payment during the organization’s taxable year is not more than two percent of the amount of the payment.” Id. § 1.513-4(c)(2)(ii). If this limit is exceeded, the entire benefit (and not just the amount exceeding the two percent threshold) provided to the payor is a substantial return benefit. Id.
72 The Treasury Regulations define an “exclusive provider” relationship as any arrangement which “limits the sale, distribution, availability, or use of competing products, services or facilities in connection with an exempt organization’s activity.” Id. § 1.513-4(c)(2)(vi)(B). “For example, if in exchange for a payment, the exempt organization agrees to allow only the payor’s products to be sold in connection with an activity, the payor has received a substantial return benefit.” Id.
73 Id. § 1.513-4(c)(2)(iii)(D).
74 Id. § 1.513-4(d).
75 Id.
76 Treas. Reg. § 1.513-4(f) (Ex. 2).
a hyperlink to the pharmaceutical company’s website. On the pharmaceutical company’s website, the statement appears, “X endorses the use of our drug, and suggests that you ask your doctor for a prescription if you have this medical condition.” X reviewed the endorsement before it was posted on the pharmaceutical company’s website and gave permission for the endorsement to appear. The endorsement is advertising. The fair market value of the advertising exceeds 2% of the total payment received from the pharmaceutical company. Therefore, only the portion of the payment, if any, that X can demonstrate exceeds the fair market value of the advertising on the pharmaceutical company’s website is a qualified sponsorship payment.77

The tax treatment of any payment that does not represent income from a qualified sponsorship payment is governed by general UBIT principles.78 The mere fact that the payments are received in connection with the corporate sponsor receiving a substantial return benefit does not necessitate the payments constituting UBTI. For example, in a memorandum released by the Internal Revenue Service in October 2001, examples of certain exclusive provider relationships were addressed.79 Significantly, one example involved a contract between a soft drink company and a university, under which the soft drink company would be the exclusive provider of soft drinks on campus in return for an annual payment made to the university. Exclusive provider relationships are explicitly named as a substantial return benefit; therefore, the arrangement did not qualify as a qualified sponsorship payment. Because the soft drink company maintained the vending machines, there was no obligation by the university to perform any services on behalf of the soft drink company or to perform any services in connection with the contract. Accordingly, the university did not have the level of activity necessary to constitute a trade or business. Since the contract also provided that the soft drink company was given a license to market its products using the university’s name and logo, the portion of the total payment attributable to the value of the license would be excluded from the university’s UBTI as a royalty payment.

If the corporate sponsorship involves the charity’s endorsement of the corporate sponsor’s product or services, then the income from the corporate sponsorship will likely be included in the charity’s UBTI as advertising income. “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.”80 Advertising includes “messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement, or an inducement to purchase, sell, or use any company, service, facility or product.”81 For example, the Internal

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77 Id. at Ex. 12.
78 Id. § 1.513-4(f).
80 Treas. Reg. § 1.513-4(c)(v).
81 Id. Typically, advertising is considered to be a trade or business that is unrelated to the charity’s exempt purposes. Thus, the question remains whether the advertising activity is “regularly carried on.” If advertising messages of a corporate sponsor’s product are continuously present on the charity’s website, such advertising activities would seem to be regularly carried on and the revenues therefrom would thus constitute UBTI. One counter-argument would appear to be that the limited number of advertisements makes the charity’s activities dissimilar in extent to comparable commercial activities. See Tech. Adv. Mem. 9417003 (Dec. 31, 1993) (stating that an advertising campaign conducted by placing advertisements in programs for an organization’s annual ball was not typical of commercial endeavors because solicitations for advertisements were limited in number and consisted of a single form letter). Given the variety and relative novelty of Internet advertisements, it would be unwise for a charity to rely upon such a position. See generally I.R.S. Announcement 2000-84, 2000-42 I.R.B. 385 (announcing that the Internal
Revenue Service considers the following messages to consist, at least in part, of advertising: (i) “This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call at 555-1234. This station is proud to have the Music Shop as a sponsor,” and (ii) “Visit the Music Shop today for the finest selection of music CDs and cassette tapes.” If a single message contains both advertising and an acknowledgement, the message is an advertisement. Where the Treasury Regulations do not allow one to clearly distinguish between advertisements and permitted uses and acknowledgements, a court may be inclined to take a common-sense approach and consider a message an advertisement if it “looks like” an ad.

The United States Supreme Court considered whether advertising could be substantially related to an organization’s exempt purposes in United States v. American College of Physicians, the leading case on this topic. There, an exempt physicians’ organization received income from the sale of advertising in its professional journal. The messages in question consisted of advertisements for “pharmaceuticals, medical supplies, and equipment useful in the practice of internal medicine.” The organization “has a long-standing practice of accepting only advertisements containing information about the use of medical products, and screens proffered advertisements for accuracy and relevance to internal medicine.” The organization argued that these advertisements were substantially related to its exempt functions because they contributed to the education of the journal’s readers. At trial, experts testified that “drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture and use.” Rejecting the organization’s claim and ruling that the advertising income was UBTI, the Supreme Court analyzed this issue as follows:

[A]ll advertisements contain some information, and if a modicum of informative content were enough to supply the important contribution necessary to achieve tax exemption for commercial advertising, it would be the rare advertisement indeed that would fail to meet the test. Yet the statutory and regulatory scheme, even if not creating a per se rule against tax exemption, is clearly antagonistic to the concept of a per se rule for exemption . . . . Thus, the Claims Court properly directed its attention to the College’s conduct of its advertising business, and it found the following pertinent facts:

The evidence is clear that plaintiff did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspect of the goods or services publicized. Those companies willing to pay for advertising space got it; others did not. Moreover, some of the advertising was for established drugs or devices and was repeated from one month to another, undermining the suggestion that the advertising was principally designed to alert readers of recent developments . . . . Some ads even concerned matters that had no conceivable relationship to the College’s tax-exempt purposes.

. . . This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the

Revenue Service was considering whether clarification was needed as to the application of the “regularly carried on” requirement to business activities conducted on the Internet).

82 Id. § 1.513-4(f), example 7.
83 Id. at example 8. Where a document can be broken down into segments identified in the Treasury Regulations, a court or the Internal Revenue Service will likely analyze each segment with reference to the rules set out above. See, e.g., Tech. Adv. Mem. 9805001 (Oct. 7, 1997) (concluding that an “ad” did not rise to the level of advertising when it consisted of a can of a sponsor’s pet food made to look like a trophy and included two slogans that had long been used by the sponsor in its advertising).
84 See, e.g., State Police Ass’n of Mass. v. Comm’r, 125 F.3d 1, 6 (1st Cir. 1997).
85 475 U.S. 834 (1986).
86 Id. at 847.
pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury.87

D. Payments Between Controlled Groups. When a charitable organization receives a “specified payment” from another entity which it controls, the payment is treated as unrelated business income to the extent the payment reduces the trade or business income of the controlled entity.88 The term “specified payment” means any interest, annuity, royalty, or rent paid to the controlling organization.89 For purposes of this rule, the term control means (1) in the case of a corporation, ownership (by vote or value) of more than 50% of the stock in a corporation,90 or (2) in the case of a partnership, ownership of more than 50% of the profits interest or capital interest in a partnership.91 In determining control, the constructive ownership rules of Code section 318 apply.92 If a partnership owns stock in a corporation, ownership of the corporation will be attributed to the partners in the same proportion in which the partners hold their interests in the partnership.93 In addition, if a shareholder owns 50% or more of the value of the stock in a corporation, stock in another entity owned by the corporation is considered as owned by its shareholder in proportion to the shareholder’s ownership interest in the corporation.94

Code Section 318 is silent with respect to applying attribution rules among tax exempt organizations. On its face, Code Section 318 does not seem to attribute ownership in an entity from one nonstock tax exempt organization to another because the attribution rules focus on one’s ownership interest in an organization. Ownership is not an appropriate criterion for tax exempt organizations because no one has an ownership interest in a nonstock tax exempt organization. For example, if two tax exempt organizations, which have identical boards of directors, each own

87 Id. at 848–50 (citation omitted). Several cases and rulings follow the reasoning of American College of Physicians. See, e.g., Minn. Holstein-Frisian Breeders Ass’n v. Comm’r, 64 T.C.M. (CCH) 1319 (1992) (holding that advertisements that may have been of “incidental benefit to breeders in running their day-to-day operations” but that did not “contribute importantly to improving the quality of the breed of Holstein-Frisian cattle” were not substantially related to a cattle breeding organization’s exempt purposes); Fla. Trucking Ass’n v. Comm’r, 87 T.C. 1039 (1986) (holding that advertisements of products of particular interest to the trucking industry did not bear a substantial relationship to the exempt functions of a trucking trade association); Rev. Rul. 82-139, 1982-2 C.B. 108 (concluding that a bar association’s publication of advertisements for products and services used by the legal profession was not substantially related to the association’s exempt purposes).

88 I.R.C. § 512(b)(13)(A). A modification to this rule applies to “qualifying specified payments” (i.e., specified payments made pursuant to a binding written contract in effect on Aug. 17, 2006) received or accrued after Dec. 31, 2005 and before Jan. 1, 2014. Under the modified rule, only the excess payments – the portion of the “qualifying specified payment” received or accrued by the controlling organization that exceeds the amount which would have been paid or accrued if such payment met the requirements prescribed under Code section 482 – is included in the controlling organization’s UBTI, and only to the extent such excess payment reduces the trade or business income of the controlled entity. I.R.C. § 512(b)(13)(E).

89 I.R.C. § 512(b)(13)(C).


a 50% interest in a for-profit corporation, the constructive ownership rules of Code Section 318 would not seem to attribute the ownership of the corporation’s stock from one of the tax exempt organizations to the other.\textsuperscript{95} Thus, since both tax exempt entities would own only 50% of the corporation’s stock, the corporation would not be controlled by either tax exempt organization.\textsuperscript{96} As a result, interest paid from the for-profit corporation to the tax exempt shareholders would not be considered unrelated business income.

However, by analogizing the principles of former Code Section 512(b)(13), ownership in an entity by one tax-exempt organization may be attributed to another tax-exempt organization if there is a common degree of management between the two tax-exempt organizations.\textsuperscript{97} Former Code Section 512(b)(13) defined control by reference to Code Section 368(c) which provides that ownership of at least 80% of the corporation’s stock effectuated control.\textsuperscript{98} In applying the principles of Section 368(c), Treasury Regulation Section 1.512(b)-1(l)(4)(i)(b) states that in the context of nonstock tax-exempt organizations, control exists between two or more tax-exempt organizations in which more than 50% of the governing boards overlap.\textsuperscript{99}

E. Unrelated Debt Financed Income. Property acquired by an exempt organization with borrowed funds may be considered debt-financed property.\textsuperscript{100} Debt-financed property is property held by a charitable organization to produce income that is encumbered by acquisition indebtedness at any time during the taxable year.\textsuperscript{101} The term “acquisition indebtedness” refers to acquisition or indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of acquisition.\textsuperscript{102} There are several exceptions to the term acquisition indebtedness, including exceptions for property acquired by gift, bequest, or devise, indebtedness incurred in performing the organization’s exempt function, and certain real property acquired by educational organizations, qualified plans, and multiple-parent title holding organizations.\textsuperscript{103} Exceptions under which property acquired with financing escapes classification as debt-financed property include property used by an organization in performing its exempt function, property used in an unrelated trade or business, and property acquired for prospective exempt use.\textsuperscript{104}

A certain portion of income derived from debt-financed property must be included in unrelated business taxable income as an item of gross income derived from an unrelated trade or business.\textsuperscript{105} Similarly, a certain portion of the deductions directly connected with debt-financed


\textsuperscript{96} \textit{See I.R.C. § 512(b)(13)(D)}.

\textsuperscript{97} \textit{See Wexler & Appleberry, supra note 83 at 363; see also Priv. Ltr. Rul. 199941048 (Oct. 18, 1999)}.

\textsuperscript{98} Former \textit{I.R.C. § 512(b)(13)} (repealed by P.L. 105-34 \textit{§ 1041(a)}) (effective for tax years beginning before August 6, 1997).

\textsuperscript{99} Wexler & Appleberry, \textit{supra} note 83 at 363.

\textsuperscript{100} \textit{I.R.C. § 514(b)}.

\textsuperscript{101} \textit{I.R.C. § 514(b)(1)}.

\textsuperscript{102} \textit{I.R.C. § 514(c)(1)}.

\textsuperscript{103} \textit{I.R.C. § 514(c)}.

\textsuperscript{104} \textit{I.R.C. § 514(b)(1), (3)}.

\textsuperscript{105} \textit{I.R.C. § 514(a)(1)}.
property are allowed as deductions in computing unrelated business taxable income.\footnote{I.R.C. § 514(a)(2).} The portion of income and deduction that must be taken into account is determined by applying a debt/basis percentage, which is equal to the ratio of the average acquisition indebtedness for the taxable year with respect to the property over the average amount of the adjusted basis of the property during the period it is held by the organization during the taxable year.\footnote{I.R.C. § 514(a)(1).}

The treatment of income and deductions from debt-financed property described above overrides the modifications from unrelated business taxable income otherwise provided for dividends, interest, payments with respect to securities loans, annuities, loan commitment fees, royalties, rents, and gains and losses from the sale, exchange, or other disposition of property.\footnote{I.R.C. § 512(b)(4).} In other words, the amount ascertained under the debt-financed property rules is expressly required to be included as an item of gross income derived from an unrelated trade or business despite the fact that the source of such income is passive in nature.

\section*{IV. Special Concerns.}

\section*{A. Partnerships.} Section 702(b) of the Code provides that the character in the hands of a partner of an item of partnership income is determined as if the item were realized directed from the source from which realized by the partnership. For example, if an entity’s share of partnership income is derived from debt-financed property, the income from the property is generally taxable as debt-financed income.\footnote{See, e.g., Rev. Rul. 74-197, 1974-1 C.B. 143. Example 4 in Treasury Regulation Section 1.514(c)-1(a)(2) specifically demonstrates that this is so. Treas. Reg. § 1.514(c)-1(a)(2), example 4. Relying upon Section 702(b), Example 4 explains that if an entity (“X”) is a limited partner in a partnership that borrows money to purchase an office building for lease to the general public, X’s share of the income from the building is debt-financed income. Id.}

Technical Advice Memorandum 9651001 indicates that the use of multiple pass-through entities does not change this result.\footnote{Tech. Adv. Mem. 9651001 (Dec. 20, 1996).} There, an exempt organization (“X”) held an interest in a limited partnership (“Z”). Z in turn owned an interest in a joint venture (“Venture”). Venture owned property that was collateral for a mortgage note. X eventually sold its interest in Z. The issue in the Technical Advice Memorandum was whether this sale was subject to unrelated business income tax under Section 511 of the Code because Z owned debt-financed property. The IRS concluded that it was, explaining, “[a]n interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result in another.” Under this reasoning, the same result follows if the income in question was derived from debt-financed property other than through a sale of the exempt entity’s interest in a pass-through entity. Regardless of how many layers of pass-through entities are imposed, the “lowest level” entity’s property would effectively be owned by each entity up the line, and would ultimately effectively be owned by the tax exempt entity.

To avoid the realization of debt-financed income through an investment in a limited partnership or hedge fund, charitable organizations often use “blocker” entities to acquire these investments. A “blocker” entity is a corporate entity that is interposed between the investment
and the charitable organization. The corporation “blocks” the attribution of any debt in the investment partnership to the charitable organization, and thus enables the charitable organization to avoid the application of the debt-financed income rules with respect to the investment income generated by the investment partnership. Rather, the partnership income is taxed to the corporate blocker entity. Often, the blocker entity is a foreign corporation formed in a low tax jurisdiction. As a result, the blocker entity pays little or no tax on the income from the investment partnership or hedge fund. The blocker entity in turn distributes the income received from the investment partnership to the charitable organization in the form of dividends, which is excluded from the charitable organization’s unrelated business taxable income. The IRS has issued a private letter ruling determining that dividends received by a charitable organization from a foreign corporation used as a blocker entity is not subject to the unrelated business income tax.

Although the use of blocker entities may appear to be a “loophole,” blocker entities are often used to avoid the application of the unrelated debt-financed income rules to passive investments that were never intended to be within the scope of the rules.

B. S Corporations. Charities are able to hold S corporation shares without breaking the S election. However, all income distributable to a charitable S corporation shareholder will be treated as unrelated business taxable income from an asset deemed in its entirety to be an interest in unrelated trade or business. Consequently, “(i) all items of income, loss, or deduction taken into account under Section 1366(a), and (ii) any gain or loss on the disposition of the stock in the S corporation shall be taken into account in computing the unrelated business taxable income of such organization.” In addition, the basis of any S corporation stock acquired by purchase is reduced by the amount of dividends received by the charitable organization with respect to the stock.

C. Public Disclosure of Information Relating to the Unrelated Business Income Tax. Charitable organizations are required to make their annual Form 990/Form 990PF information returns and exemption materials available for public inspection. Organizations that have unrelated business income also have to file a Form 990-T return. Charitable organizations described in Section 501(c)(3) are required to make their Form 990-T returns available for public inspection. Certain information may be withheld by the charitable organization from public disclosure and inspection (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the charitable organization) if the Secretary determines that public disclosure of such information would adversely affect the charitable organization. Under the

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111 See I.R.C. § 512(b)(1).
113 See I.R.C. § 1361(c)(6).
114 I.R.C. § 512(e).
115 Id.
116 I.R.C. § 512(e)(2).
118 This requirement applies to all charitable organizations which file Form 990-T returns, regardless of whether such organizations are also required to file annual Form 990/Form 990PF information returns. However, state colleges and universities which are exempt from income tax solely under Section 115 of the Code are not required to make their Form 990-T returns available for public inspection. Notice 2007-45, 2007-22 I.R.B. 1320.
commensurate in scope test, an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources. However, if a substantial portion of the charity’s income is from unrelated activities, the organization fails to qualify for exemption.

D. Effect of Unrelated Business Activities on the Charity’s Tax-Exempt Status. In order to obtain and maintain tax-exempt status, a charity must be operated primarily for the purposes described in Section 501(c)(3) of the Code. Accordingly, if a charity engages in too much unrelated business activity, it risks the loss of its tax-exempt status as no longer satisfying this operational test. There is no bright line rule with respect to how much unrelated business income a charity may receive without jeopardizing its tax-exempt status. Whether an organization has a substantial non-exempt purpose is a question of fact.

The IRS uses two alternate tests to determine whether an exempt organization’s unrelated business activity jeopardizes its exempt status: the commensurate in scope test and the primary purpose test. Under the commensurate in scope test an exempt organization may generate a significant amount of UBTI so long as it performs charitable programs that are commensurate in scope with its financial resources. The determination hinges on whether the effort expended by the charitable organization to carry out its exempt functions is commensurate in scope with the organization’s financial resources. Under the primary purpose test, if a substantial portion of an exempt organization’s income is from unrelated business activities, the organization fails to qualify for exemption.

E. Use of Taxable Subsidiaries. If a charity engages in an activity that may produce substantial unrelated business income, the charity should consider conducting the activity through a taxable corporate subsidiary wholly owned by the charity. The taxable subsidiary will be responsible for paying income tax on the net taxable income from the activity. The net income may then be distributed to the charity in the form of dividends which generally are excluded from a charity’s UBTI.

One advantage of this structure is that the activities of the taxable subsidiary normally will not be attributed to the charity. This is especially important if the conduct of the activity is so substantial that it may jeopardize the charity’s tax-exemption. Second, the charity will not be required to file a Form 990-T related to the activity, which is available for public inspection. Although the taxable subsidiary will file a Form 1120, such form is not required to be made publicly available. Third, use of a taxable subsidiary can protect the charity’s assets from liabilities arising from the conduct of the unrelated business activity and isolate those liabilities to

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123 Treas. Reg. § 1.501(c)(3)-1(c)(1).
124 In making this determination, courts may examine the amount of time or money spent on carrying out an unrelated trade or business. See Orange County Agricultural Society v. Comm’r, 893 F.2d 529 (2d Cir. 1990), aff’d 55 T.C.M. 1602 (1988) (denying exempt status where an organization received approximately one-third of its gross income from unrelated business activities).
125 See Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945) (holding that the presence of a single, non-exempt purpose, if substantial in nature, will destroy exemption regardless of the number of importance of truly exempt purposes); B.S.W. Group v. Commissioner, 70 T.C. 352 (1978); Nationalist Movement v. Comm’r, 102 T.C. 558, 559 (1994), aff’d, 37 F.3d 216 (5th Cir. 1994).
127 Id.
128 Treas. Reg. § 1.501(c)(3)-1(c)(1).

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the taxable subsidiary. Fourth, a taxable subsidiary has greater ease in claiming tax deductions under section 162 (ordinary and necessary business expense) versus under section 512(a)(1) (directly connected with unrelated trade or business expense). Finally, a taxable subsidiary can provide greater flexibility in structuring the unrelated business activity.

However, use of a taxable subsidiary may increase administrative burdens and costs of the charity. Additionally, the dividends from the taxable subsidiary may no longer be exempt from UBIT if the charity transfers debt-financed property to the taxable subsidiary. If the charity provides administrative services to its taxable subsidiary for a fee, the IRS may reallocate income between the charity and the taxable subsidiary under Code section 482. Finally, as discussed above, if the charity receives interest, rent, annuity payments or royalties from its controlled taxable subsidiary, such payment may be treated as unrelated business income to the charity to the extent the payment reduces the trade or business income of the taxable subsidiary.

129 Exempt organizations may only offset UBTI with directly connected expenses. A “directly connected” expense is one which has a proximate and primary relationship to the carrying on of the trade or business. Treas. Reg. § 1.512(a)-1(a).
130 I.R.C. § 357(c); Rev. Rul. 77-71, 1977-1 C.B. 155.
131 I.R.C. § 512(b)(13).