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A Basic Study of Unrelated Business Income Under IRC §512

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A BRIEF STUDY OF UNRELATED BUSINESS INCOME TAX UNDER IRC §511-513

I. INTRODUCTION

To understand the principles of Unrelated Business Income Tax (UBIT) it is helpful to first review the history of the Internal Revenue Code (IRC) and in particular the basic tax code rules affecting tax-exempt organizations under IRC §501(c)(3).

The first codified federal income tax laws in the USA were enacted in 1913. The Code provided that religious, charitable scientific and educational organizations would be exempt from paying the tax. It was presumed that such organizations would raise financial support by soliciting charitable donations or by selling goods and services that were related to a qualified tax-exempt purpose and, for the most part, this assumption was true. However, over the years many tax-exempt organizations found that they could have the best of both worlds. Commercial activities could be justified if it was shown that all business income was used for charitable purposes regardless of whether the business activity was related to the charitable purpose. In 1924 the U. S. Supreme Court approved the "destination-of-income test" which opened the door for many large charitable and educational organizations to engage in unrestrained commercial activity.[1]

The initial legislation was not specific about dealing with unrelated business income. Between 1913 and 1950 the IRS sometimes challenged the tax-exempt status of organizations that engaged in commercial activity. However, revoking a charity's tax-status was an extreme measure and was seldom implemented. The destination-of-income doctrine was an effective defense. Anecdotal evidence in the congressional record revealed that many charitable and educational organizations had extensive unrelated business income. In 1950, the Code was amended to allow for taxation of unrelated business income, and revocation no longer was the sole response to UBIT. Congress passed IRC §502, which specifically addressed the destination-of-income doctrine and made it clear that qualified charities could not engage in unrestrained unrelated business activities. Over the years, Congress, tax courts and the IRS have worked to organize and expand the laws affecting income generating activities and how they are to be treated. Today, it is legal and appropriate for tax-exempt charitable organizations to generate revenue by selling goods and services that are unrelated to their exemption. It is also a convoluted and complex area of law that requires careful attention by organization managers who would avoid taxes if possible and penalties for failure to report taxable income.

The following materials will explain some of the relevant tax laws as well as the business realities that affect the generation of taxable unrelated business income. References in this material to *exempt organizations* are intended to include religious, charitable, scientific research,

and educational organizations described in Internal Revenue Code Section 501(c)(3). They may also apply to other organizations described in 501(c), but different classifications often involve different limitations.

An important difference lies in whether the sales of goods and services are substantially related to the tax-exempt purposes of the seller. Any of these business activities may be commercial in nature and taxation is not necessarily dependent upon their business-like features, but on their relation to the organization's recognized exempt purposes. It is very clear in the law that tax-exempt organizations may lawfully engage in a limited amount of unrelated business activity. The challenge here is to determine how much is too much before the IRS audits the organization. Before explaining the tax laws affecting unrelated business income, it is helpful to briefly articulate the tax laws that define the nature of a tax-exempt organization under IRC §501 (c)(3).

II: A BRIEF REVIEW OF TAX LAWS DEFINING TAX-EXEMPT ORGANIZATIONS UNDER IRC §501 (c)(3)

Organizations that are exempt under IRC 501 (c)(3) include: ". . . *corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of any candidate for public office.*"[2] To better understand this tax code, it is helpful to explain five key tax rules affecting every charitable, religious and educational organization.

A. Test One: Organized Exclusively for Exempt Purposes

Charitable organizations are only tax-exempt if they are *organized* exclusively for exempt purposes. To satisfy the IRS's exclusivity test, the organization must have: (1) a written organizational document or charter that expressly describes its qualified purposes; and (2) some language in its documents that prohibits certain transactions (prohibited activities are discussed below).

The IRS has denied exemption to many organizations claiming to be religious institutions because they had other significant purposes that affected their religious purpose. For example, one church was operating a restaurant,[3] another church was substantially involved in social and political activities,[4] while another church seemed to primarily benefit a single family.[5] In each case, the IRS said that the church was not organized primarily for religious purposes. If a religious institution becomes involved with property rental activities, they must remain secondary to the religious purpose. A charitable organization that is organized for religious

purposes as well as to own and operate a camping facility for general public recreational purpose may not be a qualified for tax-exempt status.[6]

B. Test Two: Operated Exclusively for Exempt Purposes

A charitable organization must also be able to show it is *operated* exclusively for exempt purposes. The "operational test" looks to the actual activities, regardless of the organizational purposes. The IRS looks at all of the facts and circumstances, but especially the organization's sources of revenue and the nature of its expenses. It is assumed that religious and charitable institutions receive a significant part of their revenue from charitable sources such as gifts and grants. Some qualified organizations operate exclusively by assessing related fees, charging admissions or otherwise selling related goods and services. The key issue here is that the revenue is generated from substantially related activities. It is sometimes questionable when a related sales activity changes or grows into an unrelated activity. Too much income from unrelated sources such as rentals, sales of products and services, royalties, dividends, etc., may bring to question whether an organization is primarily devoted to tax-exempt purposes or otherwise. For example, a missionary aviation society lost its tax-exempt status because more than 50% of its income was from the sale of airplane parts in the mission field. [7] In another case, a religious organization operating a health food store and restaurant was determined not to be exempt because most of its funds came from the sale of food.[8] These two charities had clear charitable purposes but their revenue sources were not directly and primarily related to their tax-exempt purposes. Also, the commercial sales of food and airplane parts led the tax courts to opine that the taxpayers were only incidentally interested in the religious and charitable purposes.

No bright line test exists as to how much commercial business activity is too much. One federal tax court indicated that an organization is safe with less than 10% unrelated commercial activity[9] while another court determined that an organization with more than one-third of its income from unrelated activities may lose its tax-exempt status.[10] The IRS and the federal courts look carefully at tax-exempt organization's business activities where it appears that excessive commercial objectives are being pursued. The author believes that unrelated business activities that generate less than 20% of the gross revenues and which do not divert substantial qualified program resources would generally not jeopardize the organization’s tax-exempt status. When such revenues exceed 20% of the gross income, the organization should carefully evaluate the operational structure and consider setting up a subsidiary to conduct such business activities. Over the years, the IRS and Federal tax courts have been slowly developing the “Commerciality Doctrine,” which addresses the issue of unrelated business activity and is discussed further at Appendix A of this paper. A current activity of the U.S. Senate Finance Committee is to examine the IRS records and other informative resources to determine if tax-exempt organizations are under reporting their unrelated business income tax. This is thus a good time for every tax-exempt organization to examine its revenue generating activities and to determine if a tax liability is being incurred. By the same token, the author does not suggest that unrelated business activity is necessarily harmful to the thriving existence of a charitable organization.

The operational test also looks to the expenses of the organization. The assets must all be applied to furthering the tax-exempt purposes of the organization. PTL Ministries in Virginia lost their tax-exempt status because James Bakker was paid an unreasonably high salary. Other organizations have been put into jeopardy because too much money was expended for lobbying activities or was contributed to a political candidate.

C. Test Three: Prohibition on Private Inurement

No part of the net earnings of an exempt organization can inure to the benefit of any private shareholder or individual. "Inurement" occurs when someone who is a leader, or otherwise exercises control over an exempt organization, takes or uses money or other assets for personal use without due consideration in return. Reasonable salaries and wages are paid in return for services, so they are not considered inurement. There is no minimum amount of private inurement that is permitted. The presence of <u>any</u> inurement may be grounds for the IRS to revoke an organization's tax-exempt status.

The prohibition against inurement also implies that when a tax-exempt organization ceases to operate and dissolves the corporation, then all assets will be properly distributed to other tax-exempt organizations. The articles of incorporation should have language that anticipates this procedure.

In the past the IRS had only two ways to deal with private inurement or unreasonable compensation of nonprofit executives: (ignore it or revoke the organization's tax-exempt status). This was very unsatisfying for the IRS and for those who believe that abusive program managers should be held accountable for mismanagement. In 1997 the *Intermediate Sanctions Act*[11] was passed. This act allows the IRS to require the return of excessive compensation received by directors, officers, employees or any other "insiders" who deal with tax-exempt organizations. The Bishop's Estate in Hawaii, a wealthy trust formed from the wealth of Hawaii's last queen, Bernice Pauahi Bishop (Queen Kamehameha) was threatened with loss of exempt status due to exorbitant fees paid to its trustees.[12] The entire Board of Trustees was replaced in order to avoid that result.

D. Test Four: Legislative Activity Must Be Insubstantial

No substantial part of the activities of the organization may be the carrying out of propaganda or otherwise attempting to influence legislation. Legislative activity generally relates to efforts to encourage or discourage the passage of government ordinances or statutes. Any organization under this section of the IRC that plans to engage in legislative activities should consider filing a special tax election under IRC Section 501(h).

E. Test Five: Political Activity Is Prohibited

Religious institutions may ". . . not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." As with inurement, the IRS does not recognize any minimum safe amount of political

activity. In the past few years, many tax-exempt organizations, especially churches, have been involved in the political process. In recognition of this situation, the IRS recently issued a public statement, known as IR 92-57, warning tax-exempt organizations against endorsing political candidates, making donations to political campaigns or allowing any candidate to use the organization's resources in a way that promotes a candidate or is in anyway detrimental to another candidate.[13]

F. Test Six: Assets of Organizations Dedicated to Qualified Tax Exempt Purposes

This test is implied in the law. Today the IRS will not grant tax-exempt status to any organization that does not have a clear and written policy concerning the distribution of assets upon dissolution of the entity. In other words, the basic incorporation documents must include express language that all assets, upon dissolution, will be transferred to another qualified tax-exempt organization. State laws, under the *cy pres* doctrine, may require that such assets be distributed to an essentially similar organization or based upon the charitable theory that the intention of the charitable donors is best served if the assets are used by a similar organization.

G. Organizational Documentation

All six of these tests are generally described in the Articles of Incorporation for each tax-exempt entity. IRS Publication 557 describes the “organizational” test in its set of instructions. These instructions apply to a wide range of qualified tax exempt organizations including those that are identified under IRC 501 (c)(3). The author has developed a standard set of corporate powers and limitations that are generally acceptable to the IRS. Appendix B includes the five standard paragraphs that are appropriate for most religious and charitable organizations.

H. Federal Reporting Requirements for Tax-Exempt Organizations

The IRC requires most tax-exempt organizations to file an annual return, IRS Form 990, to report income, expenses and structural changes that may affect the organization's continued performance of its exempt purposes.[14] Churches, associations of churches and their controlled auxiliaries are exempt from this annual reporting requirement. Many religious organizations that are closely affiliated with churches may nevertheless be required to file the annual Form 990. The organization’s original determination letter from the IRS will usually identify whether the specific organization is required to provide such annual report. It is important that each organization properly files a report if required. The Form 990 is used by the IRS to identify prohibited activities and to ensure taxpayer compliance with the many rule and regulations affecting tax-exempt organizations. The Form 990 must be filed no later than the fifteenth day of the fifth month after the organization's fiscal year ends, or a penalty of $20.00 per day, up to $10,000.00, for late filing may be imposed. Most often, May 15 is the filing date for organizations operating on a calendar year.

III. A BRIEF REVIEW OF UNRELATED BUSINESS INCOME TAXES (UBIT)

Sections 511 through 515 of the Internal Revenue Code provide for the taxation of certain commercial-type revenue that is generated by the business activities of all tax-exempt entities under IRC section 501(a). More specifically, IRC section 511(a)(1) states *"there is hereby imposed for each taxable year on the unrelated business taxable income (as defined in Section 512) of every organization described in paragraph (2) a tax computed as provided in Section 11."*

The tax code goes on in section 512(a) to provide that *"...'unrelated business taxable income' is the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business..."* [15]

The language of these two sections is densely packed with several important terms that have been the focus of much debate. The next code section 513(a) provides an important definition: "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 its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. . . .* [16] The explanation of these sections beg several vital questions.

Several hundred federal tax court opinions, IRS regulations, revenue rulings and private letter rulings have been issued in an attempt to clarify the above code sections. There is considerable clarity in this area of tax law, but after more than fifty years there is considerable ambiguity when it comes to applying the law to the infinitely diverse and creative world of the tax-exempt community.

A. What Is a Trade or Business?

The first important factor in identifying UBIT is determining if an activity is a trade or business. Generally, if an organization conducts an activity that has a commercial counterpart it is a trade or business. Therefore, selling goods and/or services that appeal to the public is almost always a trade or business. Having a profit or income producing motive is also an important criteria. The conduct of a business activity that tends to maximize profit and which limits its benefits to people who can pay the full price is likely to be treated as a trade or business. For example, a church related ministry began publishing uniquely designed Sunday school curriculum as a tax-exempt religious activity. Over several years this activity grew and became competitive with for-profit publishing houses. The organization was a commercial success when the IRS finally revoked its tax-exempt status because it was operating like other commercial publishers and earning significant profit from its sales. [17] A few years later, another religious publisher came under the same IRS scrutiny. The Tax Court ruled in its favor, however, based in part, on the fact that the organization gave away a significant amount of printed religious materials. These two cases provide a good example of the "Commerciality Doctrine" which is described more fully in Appendix A.

1. The Fragmentation Rule

Sometimes the way in which a trade business or business is operated may raise the question of whether or not it is taxable. Specifically, some organizations conduct related commercial activities that incorporate a significant unrelated activity. The IRS has developed the fragmentation rule that separates a commercial activity into distinct parts. A part of this revenue may be subject to tax. For example, many organizations publish periodic magazines or newsletters. They sell advertising that may or may not be related to the organization's tax-exempt purpose. A tax may be imposed on the advertising revenue that does not contribute substantially to the tax-exempt purposes of the publisher. (See Appendix C, II.)

2. Exploitation of Related Activities

Many charities are tax-exempt because they produce and sell goods or services that serve a qualified purpose. The organization may determine that the production facility is underutilized. The excess capacity may be diverted to an unrelated activity to raise revenue for the charity. The IRS requires that the unrelated revenue be subject to UBIT. It is very complicated to properly allocate the deductible business expenses against taxable income when part of the business use generates qualified tax-exempt income. For example, a hospital provides linen services for several medical facilities in town. This would be a related business activity. The manager of the laundry determines that there is excess capacity and markets laundry services for local hotels. Proper allocation of taxable business income will be very complicated but necessary. The potential revenue to the hospital must be worth the incumbent accounting headaches.

3. Dual Use of Charitable Facilities

A situation similar to the preceding paragraphs involves the use of a facility for both qualified and not qualified business activity. For example, a college uses its dormitory and athletics facility during the school year for related purposes. Income from dormitory fees and tuition is not taxable. During the summer, the college allows private sports camps to utilize the facilities. College employees maintain the tennis courts, swimming pool and dormitory facility. The college received unrelated taxable income for the dual use of its facilities.

B. What Is a Business That Is Regularly Carried On?

Under the above definition, unrelated business activity must be "regularly carried on". Consideration of this term must be in the light of comparable frequency and continuity of similar commercial business practices). For example, one-time sales of property, like an annual church

rummage sale, would not be a regular business. However, a monthly sale would generate UBIT. Selling Christmas trees every December, by contrast, is a regular business since that is a seasonal business normally conducted once a year. Advertising revenues are another form of business that is "regularly carried on" even if a program is only published once a year. The IRS has had a running conflict with several athletic associations that publish programs for annual athletic events.[18] The IRS maintains that the promotion of advertising space in a periodic game program is a business that is carried on throughout the year. The fact that the publication is distributed for only a limited time period is not a controlling factor. The federal courts have not always agreed with the IRS. Organizations engaged in selling advertising should evaluate this matter carefully.

C. What Are Unrelated and/or Substantially Related Activities?

Perhaps the most important question that arises in the discussion of UBIT concerns what activities are substantially related and which ones are not. As a general rule, to be "substantially related," business activities must have a causal relationship to the tax-exempt purposes of the organization. The answer to the question can be determined only after reviewing the facts and circumstances of each case. Many commercial-type activities generate income while being related to a tax-exempt function. For example, fees paid by campers to attend religious or charitable camping activities are not subject to income tax. Tuition paid by students at a school and admission receipts of an opera house are also tax-exempt. The test of relatedness always looks to the basic tax-exempt purpose of the provider and asks whether the income producing activity is necessary to such purpose.

For example, a museum sells copies of the original paintings on display. The income from the sale of prints is tax-exempt because the activity promotes the museum's cultural purposes. [19] However, the sale of jewelry in the same museum store may be subject to UBIT. [20] Another example is an organization that trains unemployed people for work in the construction industry. The students construct houses which are then sold to the public. The revenue from the house sales is used to partially fund the educational program.[21] In that case, the IRS found that there was a causal connection between the charitable program and the sale of the houses and therefore the income was not subject to UBIT.

The following examples of specific cases may help to better understand this rule.

1. A monastery organized for religious purposes manufactures simple pine coffins **for** the deceased brothers of the order as well as members of the affiliated church. Coffins are sold for the interment of church members. The coffins are attractive and in much demand by the public. Over the years, market demand has greatly increased the production of coffins beyond the needs of the order and church. The IRS ruled that sales to church members are related to the purposes of the order but sales of coffins to the public are unrelated and therefore subject to UBIT. (PLR 200038049)

2. A charitable organization is organized to help women affected by poverty. A consignment shop is developed to sell a variety of useful handcrafted articles to the public. Deserving women are invited to manufacture products for sale in return for a percent of the sales proceeds. The organization generates a significant profit from the activity which is used for the charitable programs. The IRS determined that the sale proceeds were related to the charitable purpose of the organization and therefore not UBIT. (TAM 200021056; see also Rev. Rul. 76-94 and Rev. Rul. 73-128. Compare Rev. Rul. 73-127.)

3. Product sales in similar situations may turn on how extensive the operation becomes. Local sales may be related and exempt until the organization starts selling products interstate or outside of particular geographic area. IRS Reg. Sec. 1.513-1 (d)(4)(ii). Bigger seems to not be better.

4. A hospital acquired an ailing commercial fitness center operated in conjunction with the cardiac center where patients were encouraged to use the services. The IRS determined part of the revenue not to be UBIT. However, the revenue from the roller skating rink which is primarily used by the public is unrelated and taxable. (PLR 200051049)

5. A healthcare organization sells durable medical equipment. The IRS determined that the sale proceeds are not UBIT. (PLR 200051049)

6. A charitable conservation organization cuts and sells timber from land that is being conserved. The IRS determined the sale proceeds are not UBIT. (PLR 200041038)

D. Exclusions From UBIT Rules Under IRC §513.

If the three criteria described above are applicable to a particular business activity, the commercial revenue still may not be subject to UBIT. There are many exceptions to the UBIT rules. Sometimes there seems to be exceptions to exceptions to exceptions. Application of the rules may seem to be very complicated. Obviously a business activity that is substantially related to an organization's tax-exempt purpose is not covered by UBIT. However, the question of whether or not an income-producing commercial activity is substantially related to an exempt purpose is difficult to answer. A study of the many IRS revenue rulings on the subject would be helpful to the reader who works with an organization that has commercial activities,[22] since the following paragraphs provide only a brief overview of the most significant exceptions to UBIT. IRC §513 includes several specific exceptions described below.

1. Exception for Business Operated by Volunteers

If a tax-exempt organization operates a trade or business in which substantially all of the workers are volunteers, the net income will not be

subject to UBIT.[23] For example, if a youth camp was supported by local churches, the church members could plan and operate a fruit and vegetable store to help support the camp. The income from the store would be tax-exempt if all of the workers who raised and marketed the food were volunteers. If camp employees grew the food or ran the store, the income would be taxable. Another common example of this exception involves a thrift store operated by volunteers who serve in support of a hospital, a school or some other charitable organization.

2. Exception for Business Operated for the Convenience of Members, Students, Patients

Tax-exempt schools, hospitals, clubs, churches, camps and other similar institutions may operate profitable business activities that serve the convenience of students, patients, members, employees, etc. without being subject to UBIT.[24] This exception is usually associated with school cafeterias and laundries, hospital gift shops and pharmacies, sale of church choir robes and books, etc. The revenue from a summer camp store is tax-exempt provided it sells only to regular campers and staff. If a camp store is open to the general public, the income may be subject to income taxes.

3. Exception for Business to Sell Donated Merchandise

The income from selling merchandise that has been donated for charitable or religious purposes is exempt from UBIT.[25] Examples of this business activity are usually associated with thrift shops or where a theater donates tickets to a charity that in turn regularly sells them to the public.

4. Exception for Transfer of Low Cost Items in Return for Donations

If a charity regularly engages in fund-raising by selling general books or other tangible property in return for a "donation" of $25.00, the business income would probably be taxable under (IRC §513(h)(1)(A)) On the other hand, if a charity regularly includes a small tangible gift with a request for a donation, the IRS may not consider the activity to be a taxable business. Specifically if a "low-cost" item is transferred in the context of a charitable solicitation, then the income will be tax-free. In 2005 the IRS has determined that a low-cost item must have a fair market value of less than $8.30 (Rev. Proc. 2004-71). This amount is adjusted each year.

5. Qualified Public Entertainment

Many charities attract public interest by combining certain educational opportunities with otherwise commercial entertainment or amusement activities. Some of these entertainment activities generate revenue that is

tax-exempt. Specifically, most state fairs and public expositions sponsored by certain international, national, state or local programs that are similar to traditional county fairs. If a popular entertainer performs at the state fair, the admission for such activity is exempt from UBIT.

6. Qualified Convention and Trade Show Activity

Many tax-exempt organizations conduct regular conventions or trade shows that allow members to engage the public in a common forum. (IRC §513(d)(1)) Generally income from the admission fees and other related charges are not subject to income tax. This exception is only important to organizations that engage in multiple conventions during the year. Once a year does not constitute a business that is regularly carried on.

7. Lawfully Operated Bingo Games

If state law permits the conduct of bingo games for fund-raising purposes, the income will not be taxable. (IRC §513(f)) This exception was created several years ago when the IRS recognized that some churches and civic organizations raise substantial revenue by conducting weekly bingo events. This exception does not extend to other forms of gambling. Also, the sale of food, clothing, etc at a bingo event is not exempt under this rule. Of course, an annual gala that includes Bingo is not a regularly conducted business.

8. Rentals or Exchanges of Mailing Lists

Most charitable organizations maintain extensive mailing lists of people who are interested in a specific program. Such lists may be rented or sold to other concerns. Generally such rental income would be taxable since the organization must invest considerable effort to maintain the accurate list. If such list is exchanged or rented to another qualified organization, the income is not taxable. (IRC §513(h((1)(B))

9. Qualified Sponsorship Payments

Several years ago, the IRS assessed unrelated business income tax against a national collegiate athletic association that received substantial monies from commercial entities whose product would be promoted during nationally televised football games. This abrupt enforcement activity prompted Congress to quickly enact a tax provision that permitted "corporate sponsorship" income to avoid UBIT. (IRC §513(i)(1)) The rules affecting corporate sponsorship are complicated and beyond the scope of this basic study. Organizations that do solicit corporate sponsorship

income should be aware of the specific limitations on this form of activity. See Appendix C for more details on Sponsorship Income.

E. Exclusion of Passive Income, i.e., "Modifications" Under IRC 512(b).

After the new tax laws implemented UBIT it became apparent in Congress that the law was overly broad. IRC §512(b) was developed to modify the effects of section (a) taxes. The subsection was titled "Modification" and generally excludes income from "passive investments". This group of exceptions is essentially different from the exclusions described in the foregoing paragraphs. Passive investment income is inherently related to the entities' tax-exempt purposes but is nevertheless generally excluded from UBIT. The list of excluded income is described below.

1. Dividends

The dividends paid for stock interests and similar investments are not subject to UBIT.

2. Interest

Interest income from bank accounts, CDs and similar liquid investments of cash is not taxable.

3. Annuities

Charitable annuity contracts and similar investments generate business income that is not subject to UBIT. This exception includes a number of specific limitations.

4. Royalty Income

This exclusion includes a wide range of activities. Generally the use of a corporate name, logo or intellectual property such as copyright and patent rights is grouped into the category of royalties. This passive income exception applies only when the owner of the rights leases a user interest but does not actively participate in the development of the income. Affinity credit cards are a common situation involving royalties. Charities that actively promote the use an affinity card may find the royalties subject to income tax.

5. Rents or Real or Personal Property

The leasing of real estate is a complicated business. Charitable organizations often own and operate real estate that exceeds the organization's current use. Allowing other entities to rent the property

generally will not generate taxable income. An exception to this exception occurs if the rental income involves debt-financed property (these special rules are explained below). If this owner provides significant services in relation to the property lease, the income may be taxable. Example, income from short term rental of a dormitory room would not be taxable unless the agreement includes maid services such as is available at a hotel. Also, this exception may not apply to a rental arrangement conditioned upon an indeterminate event. Example, a camping organization leases agricultural land to a farmer and conditions rent on the crop produces. This situation presents a form of joint venture for business purposes and the income is taxable.

6. Capital Gains

The sale of appreciated property may create taxable capital gains. If a charity is not in the business of buying and selling investment property and it sells exempt function property, the gain is not taxable. However, the sale of debt-financed property will result in taxable capital gains. (See Below.)

7. Research Income

Many universities, hospitals and certain public safety organizations contract with the government to provide scientific research services. The activity is often an exploration of existing resources and the research for the Defense Department may not be related to the educational purposes of the college. The income produces under such research contracts is generally exempt from UBIT.

NOTE. It is important to understand that the rental of personal property is not treated as an exception to the UBIT rules. For example, public rental of horses, boating equipment etc., is not related to the campus tax-exempt purposes, will be taxable income. If sleeping rooms are rented to the general public, the income could be tax-exempt unless the room rental includes maid services, meals, entertainment or other services which take the rental activity out of the passive asset classification. If real estate is leased together with personal property, the rental may be subject to UBIT. Briefly, the rules concerning rental of combined personal and real property provide that if less than 10% of the leasehold interest involves personal property then the income is tax-exempt, but if 50% or more of the leasehold is personal property then all of the income is taxable. Further, if the personal property involved is more than 10% but less than 50%, then taxable income is ratably apportioned. All of the above rules concerning passive assets are changed if the asset was acquired using borrowed funds. The special rules affecting "debt financed" real estate are explained in the next few paragraphs.

F. Revenue from Controlled Subsidiaries

Many charitable organizations operate subsidiary corporations to conduct unrelated business activities. Business relations between parent and subsidiary involving rental income or other forms of passive revenue may be taxable. IRC Section 512 (b)(13) is an exception to the passive income exception. Generally if the parent corporation controls more than 50% of the 'vote or value" of the subsidiary, the revenues passed on to the controlling organization may be subject to UBIT.

G. Debt Financed Passive Assets – Exception to the Exception (IRC §514)

If a tax-exempt organization acquires or improves income-producing property using borrowed funds, the income may be subject to UBIT.[26] This exception is based upon the notion that tax-exempt organizations should not be permitted to go into debt to acquire income-producing property which then produces tax-free unrelated business income. This debt-financed property rule is very significant to charitable organizations that lease property to private entities. If the land being leased is subject to a mortgage, the rental income may be taxable, unless it is subject to one of the exceptions below.

1. Substantial Use Exception

If debt-financed property is substantially used in the performance of the owner's exempt purposes, then it would not be treated as income-producing property under the debt-financed exception. Therefore, income from such property will not be subject to UBIT.[27] The IRS has determined that the "substantial use exception" applies "if 85 % or more of the use of property is devoted to the organization's exempt purpose". [28] Under this rule, if an organization leased 15% or less of its land to a commercial entity the income would not be taxable even if the property is debt-financed.[29] This rule may be affected by situations involving multiple tax-exempt organizations using a building for qualified purposes in some form of joint venture or common purpose association. For example, a church owns an office building and invites other religious organizations to share space under a common purpose agreement. The owner/church may not itself use 85% of the building but this common purpose agreement may be used to cover the entire facility. Income received by the owner would not be subject to UBIT.

2. Neighborhood Land Acquisition Exception

Another important UBIT exception concerns debt-financed real estate acquired by a tax-exempt organization which is located within the "neighborhood" and intended to be used for its exempt purposes within ten years.[30] For example, if a charitable organization that expected to enlarge its facility used borrowed funds to purchase nearby land, the property could

be leased at the fair market value without creating taxable income provided the organization constructed the new facility and began to use it within ten years. Any organization that expects to receive a benefit from this rule must notify the IRS before proceeding. The rules concerning this exception are very specific and complex. Owners expecting to take advantage of this UBIT exception need to be carefully advised.

H. Application of Debt-Financed Income Rules

Calculating UBIT on income from debt-financed property is a challenging activity. A highly simplified explanation of the applicable rules starts with a careful review of the relationship between the adjusted tax basis of a building (i.e. purchase price less depreciation and losses) and the average level of acquisition debt during the tax year. For example, consider a building for which the tax basis is $100,000 and the average mortgage is $50,000 during the year. The debt-financed ratio is one half. Then consider the unrelated rental income for this building. For example, gross unrelated rental income is $15,000 and deductible business expenses are $5,000. The net rental income of $10,000 is then multiplied by the debt financed ration of one half. As a result of this simplified example, the organization has $5,000 of unrelated taxable business income. The example above assumes the tax-exempt owner does not use the building for any qualified purpose. If such owner occupied half of the building and rented the other half to an unrelated commercial entity, this tax calculation would be complicated by the allocation of expenses for the building. The owner would be permitted to deduct approximately one half of the building expenses from the gross taxable income. Allocation formulas in these cases are very important as well as complicated. The actual numbers for this tax calculation will change each year. As the debt-financed ratio changes each year, the amount of taxable income will change accordingly if the commercial tenant is not related to the owner.

NOTE: This tax calculation would not apply to a situation where this owner is a controlling interest in the tenant. Taxation of the rental income is irrespective of the debt-financed ratio.

IV. Reporting Federal Income Taxes on Unrelated Business Income

A. Consequences of Engaging in Unrelated Business Activities

A tax-exempt organization that engages in unrelated business activity does not necessarily jeopardize its tax status. If the organization properly reports the UBIT and pays appropriate income taxes, the IRS will not interfere with its other tax-exempt activities. However, it should be noted that commercial success in unrelated business activities can create other problems. Too much UBIT may bring up the question as to what the primary purpose of the organization really is. Too much UBIT may result in the loss of tax-exempt status. Failure to file tax returns and to pay taxes can result in substantial penalties. It is very important for program administrators to take the responsibility to analyze all revenue producing activities of their organization to determine if there is taxable income. See Appendix A regarding the Commerciality Doctrine.

B. Federal Reporting Requirements for UBIT

Unrelated business income tax is calculated in a manner that is similar to that of ordinary commercial corporate income taxes. The definition of gross income and the allowable business deductions are similar. One difference is that tax-exempt organizations receive an exemption for the first $1,000 of unrelated business income. There are several special rules that apply only to UBIT, some of which are described herein below. The first important step for any program administrator is to determine if income derived from a business activity is subject to income tax. If so, the potential taxes must be estimated to determine if quarterly estimated tax payments are required.

1. IRS Form 990-W; Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations.

The IRS Form 990-W is a worksheet designed to assist business taxpayers in calculating potential UBIT. This form is important because if an organization incurs UBIT in excess of $500.00 during the fiscal year, it must make quarterly estimated tax deposits prior to filing its tax return. Failure to make adequate quarterly tax payments may result in substantial penalties.

2. Federal Tax Deposit Coupons

If it is determined that quarterly tax deposits are necessary, the administrator may contact the IRS to obtain the filing forms. A Federal Tax Deposit Coupon must accompany the payment providing the taxpayer's identification and the nature of the deposit. Deposits may be made at any qualified financial institution or branch of the Federal Reserve Bank. Once a taxpayer begins making deposits, the IRS will supply preprinted deposit coupons

3. IRS Form 990-T; Exempt Organization Business Income Tax Return

The IRS Form 990-T is similar in many respects to the Form 1120 that most business corporations must file. A copy of the Form 990-T with instructions can be obtained at the IRS website.[31] Essentially, the form requires information about the taxpayer's gross income from the sale of goods or services. Deductions are permitted for the usual business expenses related to the cost of producing and marketing the income producing product. However, unlike the regular business tax return, the Form 990-T also provides for special allocation rules that are necessary to extract taxable income from other revenue that may be tax-exempt. This is always true in certain business activities that have dual objectives. Some examples of this type of income include:

a. Advertising fees from ads that are includes in publications that otherwise serve a tax-exempt purpose; (See Appendix C)

b. Rentals from sleeping public accommodations where the facility is also used for nonprofit housing such as school dormitories;

c. Restaurant receipts where the dining room primarily serves meals to students or patients but also is open to the public who are not involved in the tax-exempt charitable programs;

d. Commercial exploitation of recreational resources otherwise used in furtherance of a tax-exempt purpose, e.g. public use of bowling alleys, tennis courts, horse back riding, swimming and boating facilities, movie theater, etc. when not used by students, patients, members, etc.

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APPENDIX A

THE COMMERCIALITY DOCTRINE

The commerciality doctrine touches upon the core issue of whether or not an entity is organized and operated exclusively for a qualified tax-exempt purpose under IRC section 501(c). The discussion in the paragraphs above dealt with UBIT and permissable limits of business activities that are seen as ancillary to an otherwise qualified tax-exempt organization. Exceeding the allowable parameters of unrelated business activity (UBA) may result in income tax consequences but generally will not disqualify the organization's tax-exempt status. The commerciality doctrine addresses the essence of a tax-exempt organization in relation to its commercial activities. Rather, it is a "common law" doctrine developed in a statutory framework. Tax expert and author Bruce Hopkins[32] has carefully examined the federal tax law and is largely responsible for identifying the trend of the federal courts and the IRS as they have created the commerciality doctrine based on *obiter dicta*[33] and judicial innuendo.

Briefly, the commerciality doctrine questions whether or not tax-exempt organizations should have any permitted commercial activities. The IRS and many judges in the federal tax court system see the corporate world divided into three sections: (1) business and commercial; (2) government and nonprofit charitable; and (3) educational and religious. Nonprofits that engage in commercial activities are out of bounds. The Internal Revenue Code does not expressly support this notion. However, a line of tax court opinions are developing that tend to support each other and may one day be integrated with the Tax Code.[34] At present, a vague set of criteria suggests that some business activities are not suitable for a tax-exempt organization. The main cases involve organizations that are essentially religious or charitable but conduct their activities more like a for-profit corporation. For example, a group of people formed an organization associated with the Seventh Day Adventist Church and provided services in relation to dietary doctrine of the church.[35] The IRS argued that the food service was merely a specialized restaurant. The fact that people of the church generally frequented the establishment and the proprietors led discussions on the dietary doctrines of the church did not change the essential character of the restaurant. Patrons ordered food from a menu and paid a set price and there was no evidence that the food restrictions were required by the church as might be the case with Jewish kosher food. On appeal, the federal court affirmed the IRS in this case. Two prior federal cases involving publishers of church related materials provide additional insight into the commerciality doctrine. *Scripture Press Foundation v. United States*[36] involved a small organization in Illinois that developed Sunday school curriculum for a particular church group. Starting humbly in the early 1940s in a garage, the organization grew substantially due in part to the business skills of the managers. Initially it was tax-exempt. An IRS audit revealed the organization to be highly commercial and successful. The Court seemed to say that commercial success was incompatible with tax-exempt organizations. Nothing in the tax laws connect this quality with the qualification under Internal Revenue Code section 501(c)(3). Nevertheless the tax court affirmed the IRS, and the organization lost its tax-exempt status. At the same time on the east coast another church publisher was developing a similar product line for a different denomination. By the late 1970s, the Presbyterian & Reformed Publishing Co. (PRC), a tax-exempt entity, was growing in a marketplace that was dominated by several for-profit corporations. On audit, the IRS argued that PRC was a commercial business and moved to revoke its tax-exempt status. The Federal Tax

Court affirmed the IRS[37] citing the apparent profitability of the organization and the careful business development even though the publication was only used to support a qualified religious activity. On appeal, the Circuit Court reversed the Tax Court, ruling that commercial success did not conflict with a qualified tax-exempt purpose. Although it is difficult to reconcile Scripture Press with PRC it is clear that if a tax-exempt entity engages in a profitable activity that has an established commercial counterpart, the continued tax-exempt status is in some jeopardy and the commeriality doctrine should be carefully examined.

Creeping Commercialism.

Most of the cases that adversely affected tax-exempt organizations came about after a considerable development of a business activity that at some level was initially qualified but later became disqualified in relation to the magnitude of the activity. In other words, the organizers did not start with intention to run a commercial operation. Rather, a charitable activity grew slowly into a commercial operation because a product or service was successful and the managers were able to effectively respond to it. Often the organization starts with the help of charitable donations. After a while the business activity supplies the necessary revenue and the managers move away from the charitable support base. It is hard work to raise charitable donations, especially when a sales activity is more effective. However, the IRS sees charitable support to be a significant criteria of a qualified tax-exempt organization. Creeping commercialism is the slow transition between charitable support and commercial dependancy. Although there is no federal tax code provision that requires a tax-exempt organization to be supported by charitable donations, the absence thereof may conflict with continued standing under Internal Revenue Code section 501(c)(3). Good advice to any charitable organization engaging in commercial-type production is to carefully and consistently maintain the charitable fund-raising program.

APPENDIX B

ORGANIZATIONAL DOCUMENTS

The following paragraphs include sample provisions suitable for the organizational documents of any entity tax-exempt under IRC section 501(c)(3). The first part should briefly describe the purposes of the organization using key words from the tax code. In addition, the purpose statement will be a frame of reference for future corporate development. It should provide a brief description of the goals of the organization without explaining the process or methods of operation. The five paragraphs designated A-E are essentially required by the IRS in one form or another. Older organizations may not include this language if they were incorporated prior to the 1960's. However, in the past ten years the IRS has insisted that some version of these Articles of Incorporation be included with nearly all tax-exempt organizations.

ARTICLE ___. PURPOSES

&CORP& (the Corporation) is organized and operated exclusively for religious, charitable, educational or scientific purposes in accord with Sec. 501(c)(3) of the Internal Revenue Code of 1986 (or a corresponding provision of any future United States Internal Revenue law, referred to below as the “Code”). More specifically, the Corporation is .... [Insert here a brief statement of purpose using specific “code” words if possible.]

ARTICLE ___. LIMITATIONS OF CORPORATE AUTHORITY

A. The Corporation, being organized exclusively for religious, charitable, educational or scientific purposes, may make distributions to organizations that qualify as exempt organizations under Section 501(c)(3) of the Code.

B. No part of the net earnings of Corporation shall inure to the benefit of, or be distributable to its members, directors, officers, or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes set forth in Article 4 above.

C. No substantial part of the activities of the Corporation shall be the carrying on of propaganda, or otherwise attempting to influence legislation, and the Corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of (or in opposition to) any candidate for public office.

D. Notwithstanding any other provision of these articles, the Corporation shall not carry on any other activities not permitted to be carried on (1) by a corporation exempt from Federal income tax under section 501(c)(3) of the Code or (2) by a corporation, contributions to which are deductible under Section 170(c)(2) of the Code.

E. Upon dissolution of the Corporation, the Board of Directors shall, after paying or making provision for the payment of all of the liabilities of the Corporation, dispose of all of the assets of

the Corporation, exclusively for the purposes of the Corporation in such manner, or to such organization or organizations organized and operated exclusively for religious, charitable, educational or scientific purposes, as shall at the time qualify as an exempt organization or organizations under Section 501(c)(3) of the Code, as the Board of Directors shall determine. Any such assets not so disposed of shall be disposed of by the appropriate court of law of the county in which the principal office of the Corporation is then located, exclusively for such purposes or to such organization or organizations, as said court shall determine, which are organized and operated exclusively for exempt purposes.

[If recipient corporation upon dissolution is known, the following optional language may be used in lieu of Paragraph E above.]

E. Upon dissolution of the corporation, the Board of Directors shall, after paying or making provision for the payment of all of the liabilities of the corporation, distribute all assets, both real and personal, to &NEWCORP& of ____________, Illinois, being qualified as an exempt organization or organizations under Section 501(c)(3) of the Code, or if such organization or organizations have dissolved or are unwilling or unable to accept said assets under the conditions of Section 501(c)(3) of the Code, to another such organization or organizations organized and operated exclusively for religious, charitable, educational, or scientific purposes as shall at the time qualify as an exempt organization or organizations under Section 501(c)(3) of the Code, and shall use said assets exclusively for the purposes of the corporation in such manner, or as the Board of Directors shall determine. Any such assets not so disposed of shall be disposed of by the appropriate court of law of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as said court shall determine, which are organized and operated exclusively for exempt purposes.

APPENDIX C

TWO SPECIAL ISSUES CONCERNING

UNRELATED BUSINESS INCOME

I. Corporate Sponsorship—Final Regulations Clarify Several Issues

Several years ago the IRS surprised the world of tax-exempt organizations when it determined that corporate sponsorship income, (eg. Mobil Oil), of nonprofit intercollegiate football games, (eg. the Cotton Bowl Games), would be treated as advertising revenue and therefore taxable income. In response, Congress quickly passed a new law, IRC section 513(i), which provided a "safe harbor" for qualified corporate sponsorships making them exempt from UBIT. The actual code section is a little vague as to what is a qualified corporate sponsorship since Congress often relies upon the IRS to fill in the details with its federal income tax regulations. After years of proposals and negotiations with the public, the Internal Revenue Service issued the final tax regulations (Rev. Reg. 1.513-4(c) et.seq.) on April 25, 2002.

A. The safe harbor for corporate sponsorship income is an extension of the passive income exception to the UBIT rules. In effect, if an exempt organization conducts a related public activity and receives contributions from a corporate sponsor in return for a mere acknowledgment of the benefactor *but not an endorsement* of *products or services* the activity is considered to be passive and therefore not subject to UBIT. To the extent that the exempt organization gives an "endorsement" of the sponsor, a series of tax consequences may result.

B. "Substantial Return Benefit" describes the tangible or intangible benefit that a corporate sponsor would obtain in return for the contribution. In addition to advertising endorsement, the sponsor might receive admission tickets or special privileges that others would pay for. If a sponsor benefit exceeds 2% of the contribution, the value of the benefits is taxable as unrelated business income.

C. Factors for Qualified Sponsorship

1. Value neutral descriptions of the sponsor's products may be given; corporate sponsors may be acknowledged by name, logo and basic contact information given in public announcement; and samples of the sponsor's products may be distributed to attendees.

   a. Payments may not be contingent upon the number of attendees or other resultant effect. Sponsorship may be contingent upon the occurrence of the event but not on the results or impact on the sponsor.
   b. Exclusivity agreements may constitute a substantial benefit.

(1) Exclusive Sponsor Agreement. Exempt organization announces that the sponsor is the only one representing a particular business or industry. Permissible only if announcement does not imply endorsement and remains an expression of gratitude.

(2) Exclusive Provider Agreement. Exempt organization allows sponsor to be the only vendor of beverages, food etc. to attendees.

2. Internet Links on Websites

a. Regulations suggest that some internet links may constitute a substantial benefit to corporate sponsors. Two examples in the regulations serve as guidelines.

b. If the exempt organization's website acknowledges a sponsor's generous contributions, including its name and a link to the sponsor's website, the revenue is exempt.

c. If the acknowledgment includes an endorsement on either side of the sponsor's link there may be a substantial benefit, making the revenue taxable. Sometimes the hyperlink goes to the sponsor's web page and includes a quality endorsement by the exempt organization. A related contribution would be taxable.

II. Advertising Revenue—Calling it Royalties Won't Affect the Taxes

Advertising has many similarities to corporate sponsorship except that one is clearly taxable while the other would be exempt from UBIT. Generally, advertising is a message to the public that encourages that public to purchase a service or product. Corporate sponsors may have the same effect upon the public but the promotional aspect of advertising is reduced to mere "acknowledgment". However, the creative efforts to reduce the tax liabilities of advertising may take other forms under the passive income exclusions. Recent cases involve charitable organizations that would "license" a commercial publisher to produce regular association magazine that is primarily supported by advertising revenue. Nevertheless, the federal courts were reticent to agree with the taxpayer's position as explained below. First, following are a few examples of taxable advertising revenue.

A. Advertising Revenue

1. Income from advertising sales in any regular publication is subject to UBIT.

2. Commercial promotions on stationary billboards and kiosks, etc., are subject to UBIT.

3. When a college promotes a commercial product during a sporting or cultural event, IRS may impose UBIT.

4. Exceptions

   a. Volunteer Labor. Student newspapers run by volunteers do not incur UBIT from advertising included in regular publication. TAM 1999-14-035

   b. Single Events for Charity. Advertisements included in a special event book distributed at an annual charity ball do not generate UBIT. Rev. Rul 75-201. Note: rationale is that this is once a year event and not a regular business activity. This may not work at a school that conducts several separate events with a common plan. The events may be aggregated and the "occasional use" exception will not apply.

   c. Related Subject Material. Revenues from commercial entities that provide information about products directly related to the educational activity may be characterized as participation fees (rather than advertising income) and not subject to UBIT. *United States v. American College of Physicians*, 475 U.S. 834, 843(1986).

B. Recent Case Law

The case of *Arkansas State Police Assn. v. Commissioner,* 282 F.3d 556 (8th Cir. 2002), involves a policeman's trade association (ASPA), which is tax-exempt under Section 501(c)(6) of the tax code. The association published a periodical three times each year for the benefit of members and others who have interest in the state police activities. In 1993, ASPA contracted with the Brent-Wyatt West company (BWW) to produce, publish and distribute the trade magazine called *The Arkansas Trooper*. BWW produced articles with the help of police and ASPA officers who wrote about issues related to police work. ASPA had editorial control and BWW solicited commercial advertising and collected revenue. BWW paid all expenses related to producing the distributing the magazine. Each year BWW would pay ASPA about $25,000 plus about 26% of advertising revenue after expenses. The contract was titled "Royalties and License Agreement" and said much about the rights of BWW to use the name and goodwill and membership lists of ASPA in the publication of its magazine. Between 1993 and 1996 BWW paid ASPA $876,697.00 under the royalty agreement, which was reported as

unrelated business income that was exempt from income tax under the passive income (royalties) exception. The IRS disagreed and assessed back taxes.

On appeal, the Court held that the income received from BWW to publish and distribute the magazine was taxable advertising revenue and not truly a royalty payment. In fact, ASPA was active in the publication process. BWW may have done the solicitation of the advertising and the distribution of the magazine but all of the effort was in order to advance the purposes of ASPA. In effect, notwithstanding the language of the contract, BWW was employed by ASPA to handle the business details of publishing the association's newsletter and in all matters was the agent of ASPA as far as the magazine was concerned.

A similar issue was resolved in *National Collegiate Athletic Assn. v. Commissioner,* 92 T.C. 456 (1989) in which the NCAA contracted with a publishing company to produce and distribute a "program" for the various athletic events. The publisher sold advertising in the programs and paid NCAA royalties for the right to publish the official program in the name of NCAA. Just as in the case involving ASPA, the program was for the benefit of the tax-exempt organization which participated in the publication process. Even though the TEO did not sell the advertising, they were the main beneficiary of the commercial activity and therefore subject to income taxes regardless of the designation royalties in the contracts.

FOOTNOTES

1. *Trinidad v. Sagrada Order de Predicadores,* 203 U.S. 578 (1924).

2. IRC section 501(c)(3).

3. *Riker v. Commissioner*, 244 F.2d 220 (1957).

4. *First Libertarian Church v. Commissioner,* 74 T.C. 396 (1980).

5. *Bubbling Well Church v. Commissioner,* 74 T.C. 531 (1980).

6. The U.S. Supreme Court in the case of *Better Business Bureau of Washington DC v. United States*, 326 U. 279 (1945) rules that a single nonexempt purpose, if substantial, would destroy the exemption but a slight or comparatively unimportant deviation is not fatal.

7. *United Missionary Aviation, Inc. v. Commissioner, 60* T.C.M. 1152 (1990).

8. *Living Faith, Inc. v Commissioner.* 91-2 U.S.T.C. (1991).

9. *World Family Corporation v. Commissioner,* 81 T.C. 958 (1983).

10. *Orange County Agricultural Society v. Commissioner,* 55 T.C.M. 1604.

11. IRC section 4958. More specifically referred to as "Tax or Excess Benefits Transaction"

12. *Estate of Bernice Pauahi Bishop, a.k.a. Kamehameha Schools Bishop Estate*.

13. In the tax case of *Christian Echoes National Ministry Inc. v United States*, 470 F.2d 849 (1972), the court held the percentage test to be inadequate and devised a balance test of the overall objectives and circumstances of the organization to determine whether a substantial part of the organizations overall financial and manpower resources.

14. IRC section 6033.

15. IRC section 512(a)(1).

16. IRC section 513.

17. *Scripture Press Foundation v. United States.* 285 F.2d 800 (1961).

18. *National Collegiate Athletic Association v Commissioner.* 914 F.2d 1417 (1990).

19. Rev. Rul. 73-104, 1973-1 C.B. 263

20. Rev. Rul. 73-105,1973-1 C.B. 264

21. Revenue Ruling 55-449, 1955-2CB 599.

22. Author Bruce Hopkins provides a helpful discussion on related and unrelated business activities in Hopkins, *The Law of Tax-Exempt Organizations Eighth Ed.,* John Wiley & Sons, New York, (2003) pp. 645-786. Also for a discussion of UBIT as it affects churches and related institutions see Hammer, *Pastor, Church & Law, Second Ed.* Christian Ministry Resources, Matthews NC. 1991 at pp. 778-789. Also, there are a growing number of federal tax court cases in which tax-exempt organizations have lost their exempt status because their related business activities were conducted in an overly commercial matter: *Fides Publishers Associations v. United States*, 263 F. Supp. 924 (1967); *Christian Manner International v. Commissioner*, 71 T.C. 661 (1979); *Incorporated Trustees of Gospel Worker Society*, 510 P. Supp. 374 (1981); *Living Faith, Inc. v. Commissioner,* 91-2 U.S.T.C (1991).

23. IRC section 513(a)(1).

24. IRC section 513(a)(2).

25. IRC section 513(a)(3).

26. IRC section 512(b)(4).

27. IRC section 514(b)(1)(A).

28. Revenue Regulation 1.514(b)- l(b)(ii).

29. *Gunderson Medical Foundation v. United States* 536 F.Supp 556 (1982).

30. Rev. Reg. 1.514(b)-l(d)(l).

31. www.irs.ustreas.gov/plain/forms_pubs/forms.html

32. Hopkins, *The Law of Tax-Exempt Organizations,* 7th ed., John Wiley & Sons 1998 (see p. 629-43 for excellent discussion of the commerciality doctrine).

33. This is a Latin term meaning, loosely translated, words that lack the force of adjudication. When a court of law renders a legal decision, the judge will sometimes support the opinion with comments or observations that are not necessary to adjudicate the issue before the court. Such word communicate the judge's personal opinions but do not carry the force of law and therefore are generally disregarded by the legal system as subsequent judicial opinions are issued.

34. Of the many cases involved in the development of the commerciality doctrine, here are a few key cases in chronological order: *Better Business Bureau of Washington. D.C. v. United States*, 326 U.S. 279 (1945); *Scripture Press Foundation v. United States,* 285 F.2d 800 (Ct. Cl. 1961); *Fides Publishing Ass'n v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967); *Living Faith Inc. v. Commissioner*, 86 T.C. M. 710 (1990).

35. *Living Faith Inc. v. Commissioner*, 950 F. 2d 365 (7th Cir 1991) appld from 86 T.C.M. 710 (1990); see also *New Faith, Inc. v. Commissioner,* 64 T.C.M. 1050 (1992).

36. *Scripture Press Foundation v. United States* , 285 F2d 800 (Ct. Cl. 1961).

37. *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070 (1982); stet on appeal at 743 F2d 148 (3rd Cir. 1984).

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