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THE TAXATION OF THE UNRELATED BUSINESS ACTIVITIES OF EXEMPT ORGANIZATIONS: WHERE DO WE STAND? WHERE DO WE SEEM TO BE HEADED?

by

DONALD C. HALEY

Organizations generally exempt from federal income taxation pursuant to Section 501(c) of the Internal Revenue Code are, nevertheless, subject to taxation on income derived from any trade or business regularly carried on by them which is unrelated to their exempt purposes. While there is general agreement that Congressional concern in enacting the unrelated business income tax (UBIT) provisions centered primarily on the elimination of the unfair competition of tax-exempt organizations with taxpaying businesses, the Internal Revenue Service and most courts impose the UBIT based upon a strict interpretation of the applicable provisions of the Code and Treasury Regulations, which contain no reference to the need to show the existence of unfair competition with a commercial business.

In view of diminishing government funding and the economic limitations on private contributions, many tax-exempt organizations are undertaking a plethora of fund-raising activities designed to provide needed financial support for their tax-exempt programs. Consequently, an understanding of the criteria for the imposition of the UBIT can be extremely useful either in modifying the manner in which income producing activities are conducted, revising economic evaluations to anticipate the payment of the tax, or deciding to forego certain fund-raising activities altogether.

This article reviews the background of the UBIT, analyzes and evaluates recent court decisions interpreting the hotly debated criteria for its imposition, reviews the status and potential implications of current Congressional consideration of revisions to the UBIT, and concludes with an evaluation of the prevailing authority and the criteria for its application.

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1 I.R.C. Sec. 501(b). Also subject to the tax on unrelated business income are state colleges and universities (I.R.C. Sec. 511(a)(2)(B)) and certain charitable trusts which are not subject to the tax on private foundations (I.R.C. Sec. 511(B)(2)).
The Congressional intent and legislative history of the UBIT are extremely important to an understanding of the intense debate over its application, both at the compliance level between the IRS and exempt organizations, and at the judicial level among the Tax Court and the U.S. Courts of Appeal.

Prior to 1950, a tax-exempt organization paid no taxes on business income from activities unrelated to its exempt activities, regardless of the source. The only requirement was that such income or profits be used in furtherance of the organization’s exempt purposes. This led to allegations of widespread competition with corporations and other enterprises that were fully taxable on their profits. Congress came to view this as an unfair advantage, and enacted the Revenue Act of 1950 which imposed a tax on the unrelated trade or business income of tax-exempt organizations. While the Congressional intent was not to force exempt organizations to abandon commercial ventures, the stated primary objective of the 1950 Act was to restrain the unfair competition of tax-exempt organizations with nonexempt businesses by placing the unrelated business activities of exempt organizations upon the same tax basis as the paying businesses with which they compete.

The statutory provisions dealing with “unrelated business income” of certain tax-exempt organizations were enacted as Sections 421 through 424 of the 1939 Code. The general concept of these provisions was to impose a tax at normal corporate rates upon the “unrelated business income” of tax-exempt entities organized in the corporate form and at individual rates upon tax-exempt trusts. These tax rates are applied to the “unrelated business taxable income” less a “specific deduction” of $1,000. The return to be filed is Form 990-T.

Regulations interpreting the unrelated business income provisions of the 1950 Act were not promulgated until 1967. A major area covered by these Regulations was the definition of “unrelated business taxable income” (UBIT) as being the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in Section 512. Not only did these Regulations contain detailed definitions and de-
scriptions of the three critical components of UBIT (i.e., "trade or business," "regularly carried on," and "substantially related"), but they also contained numerous examples of the application of the definitions and principles set forth. Because these Regulations were immediately controversial and there was Congressional concern that the statutes on which they were based were not sufficiently clear to avoid continuing litigation, the Tax Reform Act of 1969 expanded Sections 512 and 513 to codify much of the substance of these Regulations. 8

Despite these early efforts of Congress and the Regulations to clarify the meaning of the term "unrelated trade or business," there has been almost continual controversy and litigation over Congressional intent, statutory content, and application of the UBIT to specific cases. A review of the key provisions of the Code and the Regulations pertaining to the definition of unrelated business taxable income is essential to an understanding of the issues that are hotly debated in a series of significant recent cases.

DEFINING "UNRELATED BUSINESS TAXABLE INCOME":
THE BASIS OF THE CONTINUING CONTROVERSY

Congressional Intent vs. Statutory Provisions

As previously noted, there is general agreement that the primary objective of Congress in enacting the UBIT provisions of the 1950 Act was to curb the unfair competition of tax-exempt organizations with taxable entities in the conduct of business unrelated to their exempt purposes. Nevertheless, in none of the definitions of unrelated taxable business income included in the statutory provisions enacted by Congress is there any reference to a requirement of unfair competition before the tax applies. For example, Sections 511-513 provide, in pertinent part:

Section 511(a)(1): Imposition of Tax. -- 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. In making such computation for purposes of this section, the term "taxable income" as used in Section 11 shall be read as "unrelated business taxable income." 9

Section 512(a)(1): General Rule. -- Except as otherwise provided in this subsection, the term "unrelated business taxable income" means 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

8 Pub. L. No. 91-172, Par. 121, 83 Stat. 487. See also, e.g., Senate Report No. 91-552, 91st Congress, 1st Sess., p. 75.
9 See I.R.C. Sec. 421(a) (1950).
the carrying on of such trade or business, both computed with the modifications of subsection (b).\textsuperscript{10}

Section 513(a): General Rule. -- The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by Section 511, 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. . . .\textsuperscript{11}

As a consequence of the lack of any requirement in Sections 512 and 513 for unfair competition with nonexempt organizations, the I.R.S., the Tax Court, and a clear majority of the U.S. Courts of Appeal have taken the position that the overriding consideration in determining applicability of the UBIT is whether the exempt organization is engaged in an unrelated trade or business which is regularly carried on.\textsuperscript{12} The basis of this view is that although the legislative history does indicate that the primary reason the UBIT was enacted to eliminate unfair competition, Congress also intended these provisions to raise revenue.\textsuperscript{13} Despite this continuing controversy over the congressional intent, Congress has not seen fit to modify or clarify either Section 512 or Section 513 with respect to this issue, in effect leaving the interpretation of the Regulations and court decisions to be applied on a case-by-case basis.

Treasury Regulations: Filling the Statutory Voids

In view of the significant interpretive voids of Sections 512 and 513, the Regulations assume a critical role as the authoritative source for application of the UBIT. A brief review of the more controversial areas follows.

1. The Definition of Unrelated Business Taxable Income

Initial Regs. 1.513-1(a) defined unrelated business taxable income as follows:

Therefore, unless one of the specific exceptions of Section 512 or 513

\textsuperscript{10} See I.R.C. Sec. 422(a) (1950).

\textsuperscript{11} See I.R.C. Sec. 422(b) (1950).

\textsuperscript{12} This rationale is frequently referred to as the "profit motive test," a position arguably confirmed by Treas. Reg. Sec. 1.513-1(b), which refers to I.R.C. Sec. 162 and its profit motive language. The opposing view is that the UBIT should be imposed only when there is further evidence that there are, in fact, nonexempt organizations providing the same or similar goods or services, thereby resulting in "unfair competition." A later section of this article identifies those courts which tend to follow either the "profit motive test" or the "unfair competition test."

\textsuperscript{13} Support for this view is found in H.R. Rep. No. 2319, 81st Cong., 2d Sess., 1950-2 C.B. 380, 381, which referred to the UBIT provisions as part of the loophole-closing measures contained in the Revenue Act of
is applicable, gross income of an exempt organization subject to the tax imposed by Section 511 is includable in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization’s performance of its exempt functions.14

Despite express recognition that the elimination of unfair competition was the primary objective in the adoption of the UBIT,15 the Regulations (like the Code) make no reference to a need to show unfair competition and provide instead a three-step test which seemingly mandates application of the tax if all three elements are met.

Test 1: Is there income from a trade or business? Regs. 1.513-1(b) links the definition of “trade or business” for the UBIT to the same characteristics of “trade or business” contained in Section 162, which generally includes any activity carried on for the production of income from the sale of goods or the performance of services. For purposes of this definition, an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Regs. 1.513-1(b) concludes with a key statement which, as discussed later in this article, has become an issue in litigation: “However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.”16

Test 2: Is the trade or business regularly carried on? Regs. 1.513-1(c) sets forth general principles and examples of their application to specific situations. The determinative factors are the frequency and continuity of the income producing activities, the manner in which they are conducted, and their similarity to comparable activities of nonexempt businesses. Intermittent activities 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

1950. The Senate Report concurred in this objective, noting that the military action in Korea “made it necessary to convert--the bill passed by the House--into a bill to raise revenues.” S.Rep. No. 2375, 81st Cong., 2d Sess., 1950-2 C.B. 483, 484.


15 The first sentence of Treas. Reg. Sec. 1.513-1(b) states:

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.

16 This language of Treas. Reg. Sec. 1.513-1(b) was codified in Section 513(c), as a part of the T.R.A. of 1969, effective 1/1/70.
endeavors.  

Test 3: Is the trade or business substantially related to the exempt functions?  
The answer to this question necessitates an examination of the relationship between 
the business activities which generate the particular income in question and the 
accomplishment of the organization’s exempt purposes.  
The Regulations require 
that such related activities must contribute importantly to the accomplishment of the 
exempt purposes, stating that a key factor is the consideration of the size and extent 
of the activities involved in relation to the nature and extent of the exempt function 
which they purport to serve.  
A number of examples are provided in Regs. 1.513-
1(d)(4) illustrating application of these principles.  
Regs. 1.513-1(e) sets forth 
several exceptions to the definition of the term “unrelated trade or business,” 
including any trade or business consisting of the selling of merchandise received by 
the organization as gifts or contributions.

2. The Unfair Competition Issue

Perhaps the most pervasive and divisive of the issues relating to the UBIT is 
the question of whether it is applicable only where there is evidence of unfair 
competition with taxable entities.  
As previously noted, although the legislative 
history indicates that the primary purpose of the tax was the elimination of unfair 
competition, there is support for the view that the UBIT was also enacted to raise 
revenue.  
Supporters of this view cite this as the reason the statutory language 
makes the UBIT applicable to any trade or business unrelated to the exempt purpose 
of the organization.

The Regulations, apparently anticipating the potential for continuing contro-
versy and litigation this issue represented, attempted to reconcile the legislative 
intent with the statutory language by providing:

However, in general, any activity of a Section 511 organization which 
is carried on for the production of income and which otherwise pos-
esses the characteristics required to constitute “trade or business” 
within the meaning of Section 162 - and which, in addition, is not 
substantially related to the performance of exempt functions - presents 
sufficient likelihood of unfair competition to be within the policy of the 
tax. . .

As discussed in the following sections of this article, this “sufficient likeli-
hood of unfair competition” provision, itself, has become part of the controversy

18 Treas. Reg. Sec. 1.513-1(d)(1).
19 Treas. Reg. Sec. 1.513-1(d)(2).
20 See note 13, supra.
21 Treas. Reg. Sec. 1.513-1(b) (emphasis added).
involving applicability of the UBIT.

**Recent Cases Construing Application of the UBIT**

**Cases Prior to the 1986 Supreme Court Decisions**

Because the statutory language of the UBIT provisions does not limit its application solely to those unrelated trades or businesses that compete with taxpaying entities, the IRS - following the Code and Regulations - has strictly applied the tax to any trade or business unrelated to the exempt purpose of an organization. This interpretation has been endorsed generally by the Tax Court, but has resulted in a sharp split among the U.S. Courts of Appeal.

For example, in a key 1978 decision the Court of Appeals for the Eighth Circuit held in *Clarence LaBelle Post No. 217 v. U.S.* that the UBIT was applicable since it was not limited in its scope to income earned by an exempt organization in competition with taxpaying entities. In fact, the court stated "the critical question under the statute is not the question of unfair competition, but whether the activity constitutes an unrelated trade or business." Two years later, this view was challenged by the Seventh Circuit in *The Hope School v. U.S.*, which, while holding that the UBIT did not apply because the activities of the tax-exempt school did not constitute a trade or business, expressly disagreed with the 8th Circuit to the extent it held unfair competition was not the primary consideration in determining applicability of the tax when an exempt organization was, in fact, operating a trade or business.

The Fifth Circuit, in its 1982 decision of *Louisiana Credit Union League v. U.S.*, adopted a view of the irrelevancy of unfair competition which was equally as aggressive as that of the 8th Circuit. After finding that income realized from insurance solicitation, debt collection, and data processing fell within the multiple objectives of Section 511, this court concluded that no proof of either actual or threatened competition was required to find that the UBIT was applicable. After noting "Although the legislative history speaks of competition, those who actually drafted the statute avoided the word as if it were the plague," and then citing the "sufficient likelihood of unfair competition" provision of Regs. 1.513-1(b), the court went even further by stating: "Thus the statute and regulations establish a conclusive presumption that the conduct of a trade or business by an exempt organization [not substantially related to exempt functions] constitutes unfair

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22 580 F.2d 270 (8th Cir. 1978).
23 *Id.*, at 275.
24 612 F.2d 298 (7th Cir. 1980).
25 *Id.* at 304.
26 693 F.2d 525 (5th Cir. 1982).
27 *Id.* at 541.
competition against taxable entities engaged in similar activities. . . ."\(^{28}\)

Similarly, the Sixth Circuit discounted the importance of an unfair competition test in the 1984 case of *Professional Insurance Agents of Michigan v. Commissioner*.\(^{29}\) Here, the court upheld imposition of the UBIT on the activities of an exempt business league which was actively involved in promoting the sale of insurance policies of a commercial insurance company to its members in consideration of a return of a percentage of the gross premiums. In affirming the tax deficiency imposed on the net earnings from this activity, the court simply noted that "...Section 513 and its regulations raise the question of motive . . ." and proclaimed motive as the "key inquiry," completely ignoring the existence or non-existence of any unfair competition with nonexempt organizations.\(^{30}\)

The 4th Circuit's position was clearly stated in the 1983 case of *Carolinas Farm and Power Equipment Dealers Assoc. v. U.S.*\(^{31}\) In this case, the court held that insurance rebates received and retained by a tax-exempt trade association was a part of a regularly carried on trade or business unrelated to its exempt functions, hence the UBIT was applicable. Key in the court's reaching this conclusion was its determination that the profit-motivated activities were for the benefit of individual members and not the association as a whole.\(^{32}\)

During this same period, the U.S. Claims Court (formerly the Court of Claims) was deciding cases involving applicability of the UBIT based upon a more flexible criteria of whether a controverted activity was operated in a competitive, commercial manner coupled with an inquiry as to its actual or potential competition with nonexempt enterprises.\(^{33}\) The Court of Appeals for the Federal Circuit was even more liberal in its reviews of appeals from the Claims Court. Hence, in reversing the U.S. Claims Court in its 1984 holding in *American College of Physicians v. U.S.*,\(^{34}\) the C.A.-F.C. held that advertising income received by the tax-exempt medical organization was exempt from the UBIT because the respondent had established the requisite substantial relationship between this trade or business and the organization's exempt purpose of contributing to the education of the medical journal's

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\(^{28}\) Id. at 542 (emphasis added).

\(^{29}\) 726 F.2d 1097 (6th Cir. 1984).

\(^{30}\) Id. at 1102.

\(^{31}\) 699 F.2d 167 (4th Cir. 1983).

\(^{32}\) Id. at 171. After reviewing the definition of a "business league" contained in Treas. Reg. Sec. 1.501(c)(6)-1,

This regulation further admonishes that the activities of such an association" should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons".

We think the Association's insurance activities constituted performance of a service for its individual members and not activities substantially related to its corporate objectives.


\(^{34}\) 743 F.2d 1570 (Fed. Cir. 1984) rev'd by 475 U.S. 834 (1986).

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readers. Similarly, in *American Bar Endowment v. U.S.*, the Court of Appeals for the Federal Circuit in a 1985 decision affirmed a Claims Court holding that the respondent was not subject to the UBIT because its activities in providing insurance to its members did not constitute a trade or business under the facts of the case. However, the Court of Appeals reversed the lower court’s determination that the retention of refunded dividends on members policies were not deductible by members as charitable contributions under Section 170. In deciding that the UBIT did not apply, the Court of Appeals held that the Claims Court used the correct standard in applying the “competitive and commercial” criteria of *Disabled American Veterans* but expressly disagreed with those courts which find the profit motive or the maximization of revenue to be the controlling factor in a determination of whether the unrelated business tax provisions apply.

With this clear conflict among the Courts of Appeal as to the proper criteria for applicability of the UBIT, the U.S. Supreme Court granted certiorari to the government’s appeals of both the *American College of Physicians* and the *American Bar Endowment* cases, rendering separate decision in 1986.

**The Supreme Court Speaks: Two Key 1986 Decisions**

1. **U.S. v. American College of Physicians**

As previously noted, the specific issue in dispute was whether advertising proceeds constituted business income unrelated to the respondent’s tax-exempt purposes. The case is particularly significant in that the Supreme Court set forth its standard for evaluating whether a disputed activity is “substantially related” to an organization’s exempt purpose.

A key initial determination of the court was that while it agreed that the 1969 revisions to Section 513(c) did establish a *per se* definition of advertising as a separate trade or business, it specifically rejected the government’s position that Congress also intended through these revisions to create a blanket rule for the taxation of advertising proceeds under all circumstances, stating:

We agree, therefore, with both the Claims Court and the Court of Appeals in their tacit rejection of the Government’s argument that the Treasury and Congress intended to establish a *per se* rule requiring the

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35 I.R.C. Sec. 513(c), as amended by the T.R.A. of 1969, created a *per se* rule as to advertising being a trade or business although, as later discussed in the appeal of *American College of Physicians* to the Supreme Court, 475 U.S. 834, 89 L.Ed.2d 841, 106 S.Ct. 1591 (1986), the elements of “regularly carried on” and “not substantially related” were not included.
37 *Id.* at 1577.
38 *Id.* at 1578.
40 *Id.* at 845-46.
taxation of income from all tax-exempt journals without a specific analysis of the circumstances.\textsuperscript{41}

The court then reviewed the approaches used by the Government, the Claims Court, and the Court of Appeals in evaluating whether the business of selling advertising space in the respondent’s journal was substantially related or, in the words of Regs. 1.513-1(d)(2), contributed importantly, to the respondent’s exempt purposes. After noting that the Court of Appeals and the respondent focused on the educational quality of the advertisements themselves while the Claims Court and the Government looked to the respondent’s manner of conducting of its advertising business, the Supreme Court endorsed the latter approach as the correct legal standard, stating:

Moreover, the statute provides that a tax will be imposed on “any trade or business, the conduct of which is not substantially related,” 26 U.S.C. Section 513(a) . . . , directing our focus to the manner in which the tax-exempt organization operates its business.\textsuperscript{42}

A unanimous court then reversed the Court of Appeals. In potentially useful dictum, the court indicated how the respondent might have controlled its publication of advertising to satisfy “the stringent standards erected by Congress and the Treasury.”\textsuperscript{43}

\textbf{2. U.S. v. American Bar Endowment}\textsuperscript{44}

This case presented two related issues for Supreme Court review: (1) whether the respondent received UBIT from its profitable insurance program and (2) whether the organization’s members were entitled to charitable deductions for the portion of their premium payments refunded to, and retained by, the respondent as dividends from the insurance companies. In contesting the government’s application of the UBIT, the respondent (ABE) conceded that its insurance program was regularly carried on and was not substantially related to its tax-exempt purposes, following the Supreme Court’s recent decision in \textit{American College of Physicians}. This left as its sole defense the remaining test under Regs. 1.513-1(a), the issue of whether the insurance program constituted income from a trade or business. The court sustained the government’s position on this question, holding that the core of ABE’s success in the insurance program was its access to its members and their highly favorable mortality and morbidity rates which presented a standard example of monopoly pricing.\textsuperscript{45} Disregarding both the Claims Court and Court of Appeals views that the retention by ABE of dividends on members’ policies were voluntary contributions to the organization, the Supreme Court not only held that the insurance program was

\textsuperscript{41} Id. at 847.
\textsuperscript{42} Id. at 849.
\textsuperscript{43} Id. at 849-50.
\textsuperscript{44} 477 U.S. 105, 91 L.Ed.2d 89, 106 S.Ct. 2426 (1986).
\textsuperscript{45} Id. at 113.
a trade or business but also found that each of the lower courts erred in concluding that the insurance program did not represent a potential for unfair competition by stating:

The undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed. *This case presents an example of precisely the sort of unfair competition that Congress intended to prevent.*

Although it did not refer to the "substantial likelihood of unfair competition" provisions of Regs. 1.513-1(b), the court rejected the Claims Court's finding of no danger of unfair competition since there was no evidence of taxable entities that compete with ABE by asserting that there was clear likelihood that other taxable organizations ABE's members belonged to also offered insurance programs with which it did compete.

In reversing the Court of Appeals on the second issue relating to the deductibility of a portion of the insurance premiums as charitable contributions under Section 170, the Supreme Court stated that the Claims Court, in focusing on the motive of ABE in operating the insurance program, applied the proper standard. Utilizing this criteria, the court found that the individual members did not demonstrate an intent to make a charitable contribution of their dividends which they were required to leave with ABE in order to participate in the insurance program.

*Post Supreme Court Decisions: The Controversy Continues*

Following these two 1986 Supreme Court decisions, there have been three recent Court of Appeals and three Tax Court decisions which have reviewed application of the UBIT. These decisions are extremely significant in that they not only indicate current administrative and judicial interpretations of the definitions of "trade or business" and "substantially related" criteria of Regs. 1.513-1(a), but they also evidence a continuing concern as to the relevance of actual or potential unfair competition as a factor in the applicability of the UBIT.

1. Recent Court of Appeals Decisions

Although arguments in the Seventh Circuit case of *Illinois Association of Professional Insurance Agents, Inc. v. Commissioner* were completed prior to the Supreme Court decisions in *American College of Physicians* and *American Bar Endowment*, the case was not decided until after these decisions were published. The

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46 Id. at 114 (emphasis added) (citations omitted).
47 Id. at 115.
48 Id. at 118.
49 801 F.2d 987 (7th Cir. 1986).
issue in this case was not decided until after these decisions were published. The issue in this case was whether the petitioner, a tax-exempt business league, was subject to the UBIT on the fees it received for performing promotional and administrative services in connection with the sale of errors and omissions insurance to its members. (The petitioner conceded that fees derived from conducting other insurance programs were unrelated business taxable income not substantially related to its exempt purposes.) In reviewing the proper criteria for deciding whether income producing activities of a tax-exempt organization constitute a trade or business, the court first noted that there was a split among the various courts: some using a profit motive test which focused on whether the activity was carried on for the production of income from the sale of goods or the performance of services, while other courts were using an unfair competition test which focused on whether the tax-exempt organization enjoys an unfair advantage over taxpaying entities or whether the activity is conducted in a competitive, commercial manner. The court then stated its view that the Supreme Court in American Bar Endowment had clarified the proper approach as one requiring a determination of whether the activity was entered into with the dominant hope and intent of realizing a profit, concluding with a presumption of unfair competition whenever any resulting trade or business is not substantially related to the performance of exempt functions. Thus, the Seventh Circuit Court of Appeals found no conflict in the two lines of cases (i.e. the “profit motive” and the “unfair competition” approaches), noting that the American Bar Endowment decision effectively reconciled the two views, even though the profit motive test was the predominant one, based on the facts and circumstances of each case.

After holding that the activities in promoting the errors and omissions insurance program was a trade or business regularly carried on, the Court then moved to the issue of whether these activities were substantially related to the petitioner’s exempt function. The focus of the court was twofold: (1) whether the errors and omissions insurance activity benefited each agent in direct correlation to his payment of premiums versus a direct benefit to the common interests of all its members (the issue of whether the activity was intended to further its exempt purposes versus a conduct of a business in which raising revenue was the primary concern) and (2) whether similar coverage was available from other sources (the issue of whether these activities were commercially competitive or were necessary to accomplish the organization’s exempt purpose). Finding that the errors and omissions insurance program only benefited members who paid premiums individually rather than the membership as a whole and that this same type of coverage was available from other taxable entities, the Court’s majority held the UBIT was applicable. A dissenting opinion took the opposite view, finding that while errors and omissions insurance was available during the periods in question, coverage was

50 Id. at 990.
51 Id. at 990-92.
52 Id. at 991.
53 Id. at 993.
difficult to obtain and there was instability in the market, thereby causing the petitioner’s program to benefit agents, the industry and the public, thereby being substantially related to the organization’s exempt purposes.

In a decision the following year in *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner*, the Seventh Circuit again found the UBIT to be applicable based on the particular facts of that case. The petitioner (FOP) received income from certain listings printed in a magazine it regularly published and distributed to its members and associate members, businesses and individuals having listings in the publication, legislators and other public officials, and others designated by the FOP from time to time. Based upon the record, the court held that this activity represented commercial advertising not exempted from Section 513, thereby constituting income from a trade or business. The FOP contended that in order for the court to reach this conclusion it first must find that the advertising amounted to unfair competition. Referring to its recent decision in *Illinois Association of Insurance Agents* wherein it held that the profit motive test and the unfair competition tests are not in conflict, the court rejected this argument stating:

No court has yet created a general exception to the unrelated business income tax based solely on a showing that the tax-exempt organization did not compete, or threaten to compete unfairly with taxpaying entities. Rather, the cases hold that activities engaged in for the production of income do not constitute a “trade or business” within the meaning of Section 513(c) where the income is derived from charitable contributions rather than from the sale of goods or the performance of a service.

After expressing the view that the evidence and potential of unfair competition is not dispositive but is only one factor a court must consider along with the organization’s profit motive, the court noted that the FOP’s magazine was similar to other national publications and almost identical to another magazine for police officers - all of which were published for profit. It concluded that the advertising revenue was unrelated business taxable income which was not subject to exclusion from the UBIT as royalties under Section 512(b)(2).

The most recent decision of a Court of Appeals is the April, 1989 decision of the Fifth Circuit in *Texas Apartment Association v. U.S*. In this case, the tax-exempt trade association (TAA) received revenues from the sale of preprinted lease forms and a landlord’s manual which contained statutes, case law, commentary and copies of TAA lease forms. Only TAA members could buy these items, although the

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54 833 F.2d 717 (7th Cir. 1987).
55 Id. at 722.
56 Id. at 722, citing its decision in *Illinois Association of Professional Insurance Agents*, 801 F.2d 987 (7th Cir. 1986).
57 Id. at 723.
58 869 F.2d 884 (5th Cir. 1989).
association did distribute free copies to a law school and to various state officials. Approximately a third of TAA’s $3 million operating revenues for the years in question came from the sale of the forms and the manual. The parties agreed that these activities constituted a trade or business regularly carried on, leaving only the issue of whether they were substantially related to TAA’s exempt purposes. Based upon its findings that the controverted activities benefited the association as a whole in its educational and lobbying programs, improved management practices in Texas, and that there were significant differences between the organization’s materials and its commercial counterparts, the Fifth Circuit found that the activities were substantially related to TAA’s exempt purposes and affirmed the District Court’s finding that the UBIT did not apply.

Significantly, the Fifth Circuit utilized a two-step test for determining the substantial relationship issue it first endorsed in its earlier Louisiana Credit Union League decision. Under this approach, an income-producing activity is substantially related to the tax-exempt function if (1) the activity is unique to the organization’s tax-exempt purpose and (2) direct benefits flowing from such activities inure to members in their capacities as members of the organization rather than as individuals. In evaluating the “uniqueness” factor the court stated it was also necessary to look at the manner in which the tax-exempt organization operates its business. The court found the materials sold were unique in that they were used extensively in educational and legislative programs and as course materials for association seminars, and that the organization as a whole (versus members in their individual capacities) received the benefits. What is perhaps most significant about this decision is that the Fifth Circuit rebutted the exclusive use of the profit motive test as being the determinative factor stating:

Essentially, the government is reduced to arguing that TAA must pay taxes on its income from lease forms and Redbooks (i.e., the manuals) solely because the association sold them for a profit instead of giving them away. However, this analysis strips away the purpose of Section 511(a)(1) and the substantial relationship test; their existence demonstrates that tax-exempt business leagues do not automatically incur taxes for all profit making activity. The district court below properly focused on the distinctive nature of TAA’s materials and the association’s use of them to conclude that they are substantially related to TAA’s purpose. The judgment is affirmed.

2. Recent Tax Court Decisions

Recent Tax Court cases, while documenting whatever unfair competitive fac-

59 693 F.2d at 535-36.
60 475 U.S. at 849.
61 869 F.2d at 888.
tors may be present, clearly indicate that determinations of this court will turn on a strict interpretation of the language of the Code and Regulations with minimal regard to either the existence of, or the potential for, unfair competition.

For example, the 1987 case of Veterans of Foreign Wars Department of Michigan v. Commissioner\(^{62}\) involved the solicitation activity of an exempt veteran’s organization which consisted of sending packages of Christmas cards to members and non-members with suggested donation amounts. The VFW made two contentions in support of its arguments that the UBIT did not apply: (1) the Christmas card program did not constitute a trade or business since there were no “sales” involved and the activity was merely a means of requesting voluntary additional dues from members and contributions from others, and (2) since there was no unfair competition its activities were not what Congress intended to tax in enacting the unrelated trade or business provisions. In rejecting these arguments the Tax Court first held that the activities constituted a trade or business because the program was undertaken with a profit motive and did not fall within the low cost article exception of the Regulations.\(^{63}\) It then rejected the argument that the UBIT was applicable only where there is a demonstration of unfair competition, citing, among other sources, the presumption of a likelihood of competition contained in a different sentence of the same Regulations referred to by VFW in support of its position.\(^{64}\) Nevertheless, the Tax Court stated that whatever the role competition may play in determining liability for the UBIT, the record of this case included sufficient evidence that the VFW Christmas card program did, in fact, compete with at least one major supplier of similar cards.\(^{65}\)

The 1988 case of West Virginia State Medical Association v. Commissioner\(^{66}\) involved a unique reversal of roles in construing the UBIT provisions. The petitioner, a medical association exempt from income tax under Section 501(c)(6), acknowledged the receipt of unrelated business taxable income from commissions

\(^{62}\) 89 T.C. 7 (1987).

\(^{63}\) The second sentence in Treas. Reg. Sec. 1.513-1(b) provides:

On the other hand, where 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 competition with taxable organizations. . . .

This sentence was added by T.D. 7392, filed 12/17/75, 1976-1 C.B. 162, 168. See, however, the following sentence inRegs. Sec. 1.513-1(b), which is quoted in note 64, infra.

\(^{64}\) The third sentence of Treas. Reg. Sec. 1.513-1(b) provides:

However, in general, any activity of a Section 511 organization which is carried on for the production of income and which otherwise possesses the characteristic required to constitute "trade or business" within the meaning of Section 162 - and which, in addition, is not substantially related to the performance of exempt functions - presents sufficient likelihood of unfair competition to be within the policy of the tax. . . .

\(^{65}\) 89 T.C. at 26.

\(^{66}\) 91 T.C. 651 (1988).
paid to it for endorsing and marketing a collection service of a commercial company. In addition, however, it offset this income with a loss resulting from the selling of advertising space in its monthly medical journal. The petitioner cited bothRegs. 1.513-1(b) and Section 513(c) which define a trade or business to include not only a complete business enterprise, but any component activity of a business (commonly referred to as “fragmenting” an enterprise into its component parts). The Association also referred to the last sentence of Regs. 1.513-1(b) which provides for the inclusion of an unrelated trade or business even if it does not result in a profit.\(^{67}\) The Tax Court, while acknowledging the validity of the authority cited by the petitioner, nevertheless sustained the I.R.S.'s disallowance of the offset of the advertising losses, holding that because the advertising activity had resulted in losses for 21 consecutive years this evidenced a lack of a profit objective and, accordingly, could not be deemed to be a trade or business.\(^{68}\)

In the most recently reported Tax Court case, National Water Well Association, Inc. v. Commissioner,\(^ {69}\) the petitioner was a tax-exempt trade association for the water well industry. Under an agreement with an insurance company, the Association actively sponsored and promoted an industry casualty insurance group policy and performed a variety of services related to the program. During the year in issue, the Association received a dividend from the insurance company, part of which was distributed to those insured under the program and part of which was retained. The I.R.S. held that the retained dividend, less expenses, constituted unrelated business taxable income. The Association's appeal was based on three assertions: (1) the activity from which the dividend was derived was not a trade or business, (2) if held to be a trade or business it was substantially related to the petitioner's exempt purpose (i.e., it supported the mutual interests and welfare of the water well industry), and (3) if held to be UBIT, it constituted a royalty payment specifically excluded from taxation under Section 512(b)(2). In rejecting each of these arguments and affirming imposition of the tax, the Tax Court first held that the activity constituted a trade or business under the test mandated by the Supreme Court in Commissioner v. Groetzinger\(^ {70}\) and American Bar Endowment which, together with other authority, required such a conclusion if the facts and circumstances indicated it was primarily engaged in for profit as evidenced by its operating in a competitive, commercial manner. It then held that such trade or business was not substantially related to its exempt functions, noting that the water well industry as a whole was not the primary beneficiary of the activities - only those individuals who paid premiums received direct benefit through insurance and the rebates. Finally, the Tax Court held that the

\(^{67}\) Supra note 16. The last sentence of Treas. Reg. Sec. 1.513-1(b) reads:

> However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification because it does not result in profit.

\(^{68}\) The authority cited by the court included Treas. Reg. Sec. 1.183-2(b)(6) and Golanty v. Comm., 647 F.2d 252 (9th Cir. 1981).

\(^{69}\) 92 T.C. 75 (1989).

dividend received by the Association did not constitute a royalty payment under Section 512(b)(2), since it was not passive income paid for the use of a valuable property right but was more akin to compensation for services rendered.

**WHERE WE STAND NOW: AN EVALUATION OF THE ONGOING CONTROVERSY**

**Areas of General Agreement**

1. **Validity of the Treasury Regulations**

   As previously noted, the Regulations have assumed an even greater than usual role as an authoritative source for application of the UBIT. Regs. 1.511-1.514 contain definitive, detailed definitions, interpretations, and examples which have variously been endorsed by Congress\(^7\) and consistently applied by the courts.\(^7\) Hence, the provisions of these Regulations are consistently cited by litigants in their arguments and the courts to support their decisions.

2. **Acceptance of the 3-step approach of Regs. 1.513-1(a)**

   Relying upon the language of Code Section 512(a)(1), Regs. 1.513-1(a) expressly sets forth a 3-part test to be used in determining applicability of the UBIT. The U.S. Supreme Court referred to and endorsed this approach in *American Bar Endowment*,\(^7\) citing therein its acceptance of this approach in *American College of Physicians* also. The Supreme Court acknowledged that all three (3) criteria must be met in order for the UBIT to apply.

3. **Acceptance of the “Trade or Business” definition and principles of Regs. 1.513-1(b)**

   The cases reviewed herein confirm the general acceptance of the basic provisions of Regs. 1.513-1(b) by the courts. This includes:

   * The use of the same criteria in determining “trade or business” for the UBIT as used elsewhere in the Code and Regulations (e.g., for Section 162).

   * The exception from the definition of “trade or business” low cost articles distributed incidental to the solicitation of charitable con-

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\(^7\) See, e.g., *supra* notes 8 and 16.

\(^7\) In none of the cases cited herein have the validity of the Regulations been challenged. The Supreme Court in its 1986 decisions in *American College of Physicians* (475 U.S. 834, 89 L.Ed.2d 841, 106 S.Ct. 1591) and *American Bar Endowment* (477 U.S. 105, 91 L.Ed.2d 89, 106 S.Ct. 2426) repeatedly referred to and utilized various provisions of these Regulations without questioning their authority.

\(^7\) 477 U.S. at 109-10.
tributions.

* The concept of "fragmenting" the activities of an exempt organization to identify component trades or businesses which may, or may not, be related to its exempt purposes.

* The inclusion of an activity as a trade or business for the UBIT, even if it does not result in a profit.

As later discussed, however, the cases reviewed clearly indicate there are still disputes as to the application of these principles to specific factual situations.

4. A "facts and circumstances" approach in defining "unrelated trade or business"

Although courts deciding each of the cases cited herein either expressly or impliedly acknowledged the need for a "facts and circumstances" approach in evaluating the unrelated trade or business criteria, the Supreme Court, in its two 1986 decisions, emphasized this as a fundamental prerequisite to the proper imposition of the UBIT in each of its 1986 decisions. This approach is endorsed by the litigants and the courts in the cases decided since these Supreme Court decisions.

Major Areas Still at Issue

1. Significance of "unfair competition"

 Despite the general acceptance of the three-step approach of Reg. 1.513-1(a) and the Supreme Court's identification of the "facts and circumstances" approach as the required standard determinative of the unrelated trade or business criteria, the controversy over the relevance of the presence or absence of competition with taxable entities continues. While the decisions in each of the Court of Appeals and Tax Court cases involving the unrelated trade or business issue which were decided after publication of the 1986 Supreme Court decisions allegedly turned primarily on the manner in which the controverted activities were conducted (i.e., the facts and circumstances), these courts - as did the Supreme Court itself in American Bar Endowment - found it prudent to state whether it found actual or potential competition with taxpaying entities to exist.

74 See American College of Physicians, 475 U.S. at 845-47, where the Court categorically rejected a per se imposition of the tax where advertising income was realized, noting that although Congress did incorporate advertising in its Section 513(c) definition of "trade or business" it did not so incorporate it into the provisions related to "regularly carried on" or substantially related.

75 477 U.S. at 114.
For example:

In *Texas Apartment Association*, the Fifth Circuit, in finding the contested trade or business was substantially related, held that the activities were "unique to the organization's tax-exempt purpose" and that there were "significant differences between TAA's materials and their commercial counterparts..."76

In *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41*, the Seventh Circuit stated: "The Trooper was similar to other national publications and almost identical to Law and Order, another magazine for police officers published for profit. Thus, it is likely that these other publications suffered the ill effects of competing with *The Trooper's* lower costs..."77

In *Illinois Association of Professional Insurance Agents*, the Seventh Circuit stated: "Finally, the sale of malpractice insurance is a business ordinarily carried on by for-profit organizations. Such insurance was available from other sources, presumably provided by tax-paying entities..."78

In *National Water Well Association, Inc.*, the Tax Court after citing both Regs. 1.513-1(b) and *American Bar Endowment* as holding a presumption of the likelihood of competition being sufficient, nevertheless stated: "Thus, to the extent that unfair competition is a factor... we find that petitioner could unfairly compete with taxable... commercial organizations that could provide petitioner's members and others in the water well industry with casualty insurance, but would be taxed on their profits..."79

In *Veterans of Foreign Wars, Department of Michigan*, the Tax Court, again after disavowing the need to evidence unfair compensation stated: "there is no doubt that petitioner's product displaces and competes with Christmas cards marketed by commercial, taxpaying entities..."80

Thus, the presence or absence of competition with taxpaying entities remains a disputed factor, expressed now primarily as a "fact or circumstance" which is accorded varying degrees of importance, depending upon the significance each Court philosophically believes the statute requires it as a consideration.

76 869 F.2d at 887.  
77 833 F.2d at 723.  
78 801 F.2d at 994.  
79 92 T.C. 75 (1989).  
80 89 T.C. at 33.
2. Interpretation of agreed-upon principles of Regs. 1.513-1(b) defining "trade or business"

Despite the general agreement that the criteria enunciated in Regs. 1.513-1(b) are to be used in evaluating the existence of a trade or business, there is continuing controversy over application of these principles to particular fact situations. Hence, in Veterans of Foreign Wars, Department of Michigan, Inc., the court was faced with the issue of whether the "low cost article" exception applied, while in Virginia State Medical Association, the court had to decide the applicability of the "fragmenting" principle coupled with a determination of whether the loss-producing component business was conducted with a profit motive.

These cases clearly chart a shift in the litigation of disputes, moving from those based on principles and definitions of a trade or business to those involving the application of agreed upon criteria to specific fact situations.

3. Criteria for "substantially related" trade or business

As previously quoted, the statutory definition of "unrelated trade or business" includes any trade or business which is not substantially related to the performance or accomplishment of an organization's exempt function.\(^1\) As interpreted by the courts, this essentially makes the issue a determination which will depend upon the facts and circumstances of each case. Although Regs. 1.513-1(d) attempts to provide general guidelines to be followed in making this determination, the "substantially related" issue remains the most controversial area both at the compliance and judicial levels.

At the heart of this dispute are the differing views of the I.R.S., exempt organizations, and, to varying degrees, the Courts of Appeal over critical underlying criteria such as: the significance of the presence or absence of competition with a paying entity; the nature of the required causal relationship between the controverted activity and an exempt purpose; whether the benefits of the activity inure to the organization as a whole or to members in their individual capacities; and the degree of awareness and acknowledgement required, if any, from those connected with the trade or business that its objectives are philanthropic rather than commercial. The foregoing analysis of the differing positions taken by the I.R.S., exempt organizations and the courts, before and after the 1986 Supreme Court decisions, clearly illustrate the ongoing significance of this issue.

\(^1\) I.R.C. Sec. 513(a).
TAXATION OF EXEMPT ORGANIZATIONS

WHERE DO WE SEEM TO BE HEADED?

Short Term Prospects: Continued Controversy and Litigation

The legislative history, statutory provisions and the Regulations are consistent with an intent of Congress that the application of the UBIT is to be based on a facts and circumstances approach in each individual case. The Supreme Court, in its 1986 decisions in American College of Physicians and American Bar Endowment has confirmed this view, rejecting any *per se* applications of the tax and requiring that the three-step test of Regs. 1.513-1(a) be met.

This necessarily focuses the controversy on a case by case evaluation on whether the income producing activities constitute a trade or business and, if so, whether such trade or business is substantially related to the organization's exempt purpose, since the issue of "carrying on" such activities is usually susceptible of resolution. Since the Code, Regulations and the courts make clear that the trade or business definition for purposes of the UBIT is the same as for Section 152, the prospects for continuing disputes between the IRS and exempt organizations and resulting litigation are increased, in view of the Supreme Court having also established a facts and circumstances approach to the resolution of this single factor. Similarly, the disagreements over whether a trade or business is substantially related to an organization's exempt objectives are certain to increase, despite the Supreme Court's efforts to provide guidance by requiring an analysis of the manner in which the tax-exempt organization operates its business in making the determination. If, as is implied by this standard, the issue of unfair competition becomes secondary at best, the range of relevant criteria to properly be used is narrowed. Unfortunately, however, the subsequent decisions of lower courts indicate that because of this continuing uncertainty over the relevance of competition with taxable entities, there has been a shift in the nature of the debate of this issue rather than a consensus as to its significance.

The Court of Appeals and Tax Court decisions since American College of Physicians and American Bar Endowment illustrate the continuing diversity in emphasis, if not interpretation, of criteria to be used in the dual facts and circumstances evaluation of, first, whether specified activities constitute a trade or business and,

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82 Commissioner v. Groetzinger, 480 U.S. 23, 94 L.Ed.2d 25, 107 S.Ct. 980 (1987). The Supreme Court referred to "the Code's wide utilization in various contexts of the term trade or business" and the absence of an all-purpose definition in the Code of Regulations. 480 U.S. at 27. Thus, the Court held that the resolution of whether an activity was a trade or business depended on an examination of the facts of each case. 480 U.S. at 36.

83 American College of Physicians, 475 U.S. at 848-49.

84 As previously noted, the Supreme Court has possibly contributed to this uncertainty by its references to the fact that actual or potential competition with taxable organizations was the primary concern of Congress in enacting the UBIT noting the existence of such potential in both American College of Physicians and American Bar Endowment.
then, whether any such trade or business meets the “substantially related” test. Since each determination, standing alone, is open to differences of opinion based upon good faith efforts to apply the standards enunciated by the Regulations and the Supreme Court, the combination of these two factors as necessary requirements for application of the UBIT merely guarantees an increase in the level of controversy.

Potential for Congressional Action

On September 12, 1986, the Chairman of the House Ways and Means Committee directed the Subcommittee on Oversight to conduct a comprehensive review of the UBIT. A stated purpose of this study was to determine whether the current rules provide appropriate standards for determining the taxability of the income-producing activities of tax-exempt organizations. After accumulating its findings and holding public hearings in 1987 and early 1988, on June 23, 1988 the Subcommittee made public a draft report which contains a number of far-reaching, controversial proposals. Although these proposals are still in draft form and there is no information on when they will be presented to the full Ways and Means Committee, they remain the most viable conceptual starting point for future legislation revising the UBIT provisions.

Much of the testimony at the Subcommittee’s public hearing related to concerns over the current requirements for a facts-and-circumstances test of whether a trade or business is substantially related to an organization’s exempt purposes as a condition for imposition of the UBIT. Significantly, representatives of the small business community expressed particular concern that this criteria permits undue expansion of profit-making activities which compete with taxpaying commercial entities. Notwithstanding pressure to completely overhaul the UBIT provisions, the Draft Report recommends retention of its basic structure. This includes keeping the substantially related test as the rule of general applicability, and retention of the exclusions from the UBIT for activities that are not regularly carried on, where substantially all the work is performed by unpaid volunteers, or that involve the sale of donated merchandise. It would, however, add specific provisions requiring imposition of the UBIT to eleven categories of income producing activities, with specified limited exceptions.

Another recommendation of far-reaching significance would replace the

86 These eleven categories are: (1) sale of goods through gift shop, bookstore, catalog, and mail order activities; (2) medial sales; (3) fitness, exercise, and health-promotion activities; (4) travel and tour activities; (5) food sales or services ancillary to the exempt purposes; (6) veterinary services; (7) operation of hotels patronized by the general public; (8) real estate sales of condominiums and time-sharing units; (9) affinity credit cards and merchandising activities; (10) theme or amusement part activities; and (11) testing activities other than testing for public safety certification purposes.
facts-and-circumstances standard with more specific rules in designated areas, including:

* Computational guidelines for the allocation of expenses of dual-use facilities and for other designated income and expense items.

* A per se rule that income from advertising is subject to the UBIT without deduction of readership expenses.

* More restrictive rules for the exclusion of royalties from the UBIT.

* Reduction of the current law requirement of 80% of combined voting classes of stock and 80% of all other stock to a "more than 50%" level in defining "control" of a subsidiary for purposes of including its unrelated business activities with that of the parent for purposes of the UBIT. This would replace the present exclusion of "uncontrolled" subsidiary payments of interest, rents, royalties, and annuities to the parent.

* Repeal of the "convenience exception" of Sec. 513(a)(2) related to exclusion from the UBIT of any activity conducted primarily for the convenience of an exempt organization's members, students, patients, officers, or employees.

Most of the other rules for inclusion and exclusion of designated activities in current law and regulations would be retained without change. These recommendations have resulted in reports of fundamental disagreements among Subcommittee members and there is some question as to if, as well as when, they will be submitted to and adopted by the full Ways and Means Committee. Nevertheless, there is considerable pressure from both the small business community, the Small Business Administration (SBA) and other concerned organizations that Congress take some action to make imposition of the UBIT more certain and applicable to a broader range of income-producing activities of exempt organizations.

**SUMMARY AND CONCLUSIONS**

Underlying the disputes over application of the UBIT are disagreements over two fundamental issues: (1) the basic intent of Congress in enacting these provisions, and (2) the appropriate criteria to be used in the determination of unrelated business income on which the tax is imposed. The foregoing analysis reviews the nature and the intensity of the differing views on these issues, analyzes and evaluates the underlying causes of these differences, and provides guidance as to current standards established by the U.S. Supreme Court in its two 1986 decisions and their subsequent interpretations by the lower courts.
The history of the UBIT has been one of continuing controversy over its application to specific situations. There presently is increasing pressure on Congress to modify the UBIT provisions not only to provide greater certainty as to their application than now results under the facts-and-circumstances approach, but also to lessen the potential for competition with taxpaying entities. The current draft proposals of a subcommittee of the House Ways and Means Committee recommends retention of the basic structure of the UBIT, including the unrelated business income provisions. However, there is a distinct possibility of more fundamental and more stringent changes if, as occurred in enactment of the original 1950 provisions, this issue becomes entangled in a general objective of Congress to raise revenues.

The logical beginning in understanding the complexity of the controversy is an appreciation of the dilemma Congress was facing in 1950 and has continued to face to the present time: the need to support the efforts of tax-exempt organizations to obtain funds to conduct and further their exempt purposes while, at the same time, eliminating the perceived inequity of such organizations competing with taxpaying entities. Although the published committee reports of both the House Ways and Means Committee and the Senate Finance Committee identify the elimination of unfair competition as the primary objective of the legislation subsequently enacted, the disagreement over the significance of this underlying intent as a factor in asserting the UBIT is fundamental to much of the ongoing controversy.

As previously noted, Regs. 1.513-1(b) included an express statement that the elimination of unfair competition was the primary objective of the UBIT at the time it was issued in 1967, and that language has remained unchanged to the present time. Nevertheless, the cases reviewed herein clearly indicate that the I.R.S. has consistently assessed the tax based on a strict interpretation of Sections 511-514 and Regs. 1.513-1(d)(1). This indifference of the I.R.S. to the presence or absence of unfair competition is also graphically illustrated in a recent Private Ruling in which it held that the UBIT did not apply to income derived by a telephone cooperative from the sale and service of telephones and accessories to member and nonmember patrons who purchased their telephone systems from the cooperative, since these activities had a “substantial causal relationship” to the cooperative’s exempt purposes.\(^\text{87}\) The obvious fact that these activities competed with products and services offered by taxpaying entities was not raised as an issue in this ruling.\(^\text{88}\)

The Tax Court, as it did before the 1986 Supreme Court decisions, continues to follow the “profit-motive” approach and has discounted, but not ignored, the relevancy of the unfair competition criterion, taking the view that, at most, it is

\(^{87}\) Ltr. Rul. 89-150-06. (Jan. 12, 1989.) This ruling also held that the UBIT did apply to income from similar sales and services provided to nonmembers who did not purchase their telephone systems from the cooperative.

\(^{88}\) This is precisely the result which illustrates the concern behind much of the pressure on Congress to revise the “substantially related test” to require application of the UBIT whenever actual or potential “unfair competition” exists.
merely one factor to be considered. Citing the Supreme Court’s focus on whether the controverted activities were conducted in a competitive, commercial manner as a constituting tacit endorsement of the profit-motive approach, the Tax Court aggressively applied this standard in its recent *National Water Well and Veterans of Foreign Wars, Department of Michigan* decisions. Significantly, each of these decisions were handed down within the Sixth Circuit which also had previously followed the profit-motive approach. Whether this somewhat narrow approach will be sustained in other circuits remains to be seen.

In response to the standards established in *American College of Physicians* and *American Bar Endowment*, the recent decisions of the Courts of Appeal have been more broadly based. Hence, in deciding *F.O.P. Illinois State Troopers, Lodge No. 41* and *Illinois Association of Professional Insurance Agents*, the Seventh Circuit not only evaluated the manner in which the profit-producing activities were conducted but also reconciled this factor with the potential for competition with taxable entities. The Fifth Circuit, in *Texas Apartment Association* reaffirmed its use of a two-step approach in deciding the “substantially related” issue, first determining whether the activities were unique to the organization and its objectives, and then evaluating whether the direct benefits inured to the organization as a whole or to members in their individual capacities. This two-step approach establishes practical, pragmatic guidelines which can be reliably used to determine whether a trade or business is substantially related to an organization’s exempt purposes.

In view of the foregoing analysis, tax-exempt organizations and their advisers should evaluate all income-producing activities to assess their vulnerability to the UBIT under the more rigorous standards established in *American College of Physicians* and *American Bar Endowment*. The Fifth Circuit’s decision in *Texas Apartment Association* indicates that the opportunity to obtain necessary funds for tax-exempt organizations without imposition of the UBIT still exists so long as (1) the income-producing activities are unique to, and contribute importantly to, their exempt purposes and (2) the benefit is realized by the organization as a whole rather than only by members in their individual capacity. If the income-producing activities of an exempt organization are, in the truest sense, unique to their exempt objectives so that competition with taxpaying entities will ordinarily be precluded, two significant benefits should result: the probability that the UBIT is inapplicable will increase, and the primary concern behind the pressure on Congress to broaden its application will be diminished.