

# UNRELATED BUSINESS INCOME TAX AND RELIGIOUS ORGANIZATIONS: AN ANALYSIS OF ITS PAST, PRESENT AND FUTURE APPLICATIONS

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## I. INTRODUCTION

Religious organizations have contributed prominently to and continue to play a growing role in American public life. They have been the foundation of moral fabric and fundamental values which energized many of the early Americans in developing sound communities and evangelizing the western frontiers.<sup>1</sup> All of these noteworthy achievements have propelled religious organizations into numerous activities resulting in escalating revenues, while at the same time allowing them to enjoy, for the most part, an exemption from federal income taxation on the revenues generated. Since the range of activities for tax exempt religious entities extends from the marketing of products to the operation of businesses, complaints about unfair compensation and abuse of the preferred status associated with their tax exempt status have expanded.<sup>2</sup>

The history of exemption from taxation for religious organizations has been recognized since the inception of Western civilization.<sup>3</sup> The formal origin of the preferred status can be found in the English Statute of Charitable Uses which dates back to the early part of the seventeenth century.<sup>4</sup> In America, the application of the exemption from taxation was incorporated in the early state constitutions. From the outset of formal taxation in America at the federal level, the practice of exempting religious organizations was instituted in the Tariffs Acts of 1894,

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<sup>1</sup> See generally Robert A. Buzzard & Lynn R. Buzzard, *Render Unto Caesar*, Unrelated Business Income Tax: Liabilities of Churches and Ministries (1990).

<sup>2</sup> *Id.* at 11.

<sup>3</sup> Joel E. Davidson, *Religion In Politics and The Income Tax Exemption*, 42 Fordham L. Rev. 397 (1973).

<sup>4</sup> GEORGE H. BANGERT, *GUIDE TO UNRELATED BUSINESS INCOME TAX* 19 (1994).

1909, and the Revenue Act of 1913; specifically, after the Sixteenth Amendment was ratified, Congress exempted from taxation any corporation or organization operated exclusively for religious purposes. Consistent with the recodification of the Internal Revenue Code (the Code) in 1939, the House of Representatives legally defined the term *exemption* as based upon the premise that organizations exempt from taxation would in turn perform services for the public that are usual and commonplace for the government to perform.” Thus, entities afforded the exemption from tax were expected to avoid commercial enterprises, with the deterrent being taxation on the profits from such endeavors.<sup>7</sup>

For a lengthy period of time, the exemption from income tax continued to be applied to qualifying religious organizations. During this period of no intrusion, several key global developments encouraged much criticism and indictments of abuse, prompting intense scrutiny of these activities by the Treasury Department, Congress and President Harry S Truman.

The first global abuse was prominently noted by the United States Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*.<sup>8</sup> The Court determined that an exempt organization would not lose its tax exempt status due to income generated from direct ownership of commercial enterprises, regardless of how much income was generated. In *Trinidad*, the court emerged with the *destination of income test*. Under the protection of this doctrine, tax exempt organizations would retain their tax exempt status so long as all of the tax free income from unrelated activity was deployed for on-going operations or to expand the scope of the activity of the tax exempt organization.<sup>9</sup> Such unrelated activity was characterized as being incidental to the exempt purposes of the organization.<sup>10</sup>

The second global abuse involved a disguised purchase transaction by a tax exempt entity with borrowed money. The entity then leased the property back to the seller at an amount seemingly equivalent to the sum of the purchaser mortgage payment and depreciation expense. The seller in such a transaction routinely benefitted by hav

<sup>5</sup> *Id.* at 19.

<sup>6</sup> *Id.*

<sup>7</sup> Donald C. Haley, *The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem To Be Headed?*, 7 Akron Tax J. 62(1990).

<sup>8</sup> 263 U.S. 578 (1924).

<sup>9</sup> Bangert, *supra* note 4 at 5,19.

<sup>10</sup> *Id.* at 20.

ing reduced lease payments because the tax exempt organization was not taxed on the lease income.<sup>11</sup>

These abuses were dramatically significant, and prompted a massive competitive advantage. With the Korean War unfolding, the abuses were fortunately terminated with the passage of the Revenue Act of 1950.<sup>12</sup> Congress was clearly judicious and prudent to thwart such abuses of unfair competition and to correspondingly raise monies needed to finance the war through a host of essential tax changes.<sup>13</sup>

The Revenue Act of 1950 left untouched religious organizations and governmental entities, other than colleges and universities and certain other specified entities. However, it instituted two significant changes applicable to exempt organizations that generate income from unrelated activities: 1) it eliminated tax exempt status for *feeder organizations*, entities whose exclusive purpose was to generate revenue through a trade or business for the parent exempt organization; and 2) it enacted "unrelated business income tax" Section 511 through Section 514 of the Code.<sup>14</sup>

After Congress noted the abuse of loopholes by exempt organizations, particularly concerning rentals, lease-back schemes and interest payments, it undertook a new legislative approach and passed the Revenue Act of 1969<sup>15</sup> which extended unrelated business income tax primarily to all exempt organizations. In particular, the Act extended the application of the tax to churches in 1975 by specific reference.<sup>16</sup>

In recent years, many of the exempt organizations not subject to unrelated business income tax such as churches, social clubs . . . began to engage in substantial commercial activity. For example, numerous business activities of churches were brought to the attention of the Congress. Some churches are engaged in operating publishing houses, hotels, factories, radio and television stations, parking lots, newspapers, bakeries, restaurants, etc.<sup>17</sup>

The Revenue Act of 1969 also gave a different twist to the term *trade or business*. In particular, this law advanced the *fragmentation rule* providing that unrelated business activity could exist within the aggregate of an ongoing activity which is legitimately tax exempt.<sup>18</sup>

<sup>11</sup> *Id.* at 21. See also H.R. Rep. No. 91413, 91st Cong., 1st Sess. pt. 1, at 45 (1969).

<sup>12</sup> Revenue Act of 1950, Pub. L. No. 81-814 § 301, 64 Stat. 906 (1950).

<sup>13</sup> Buzzard & Buzzard, *supra* note 1, at 22.

<sup>14</sup> *Id.* at 33-34.

<sup>15</sup> Revenue Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

<sup>16</sup> 1.R.C. § 511(a)(2)(A) (1969).

<sup>17</sup> Joint Comm. on Int. Rev. Tax., 91st Cong., 2d Sess. General Exploration of Tax Reform Act of 1969, at 6667 (1970).

<sup>18</sup> 1.R.C. § 513(c) (1969).

For example, the selling of folk art and souvenirs by a tax exempt museum to the public resulted in unrelated business income tax even though the bulk of the sales by the tax exempt organization was related to its tax exempt purpose.<sup>19</sup> The tax law changes of 1950 and 1969 resulted in some major changes in unrelated business income tax. The tax acts in 1978 and 1986 were of limited consequence and importance to tax exempt organizations.<sup>20</sup>

## II. DEFINITION OF UNRELATED BUSINESS INCOME TAX

Religious organizations' involvement in business activity has raised and continues to raise the question of whether or not such activity is permissible for a religious organization or church. Although the dynamics of taxation have evolved over time, the answer to the question remains firm and formidable. Generally, a religious organization or church may engage in a profit-making activity so long as the involvement represents only an insubstantial part of the overall activity, the majority of which must be related to its tax exempt purpose.<sup>21</sup> In order for the activity of a religious organization, church or other tax exempt entity to qualify for and be subject to unrelated business tax, such activity must satisfy all three of the following criteria: 1) the activity must be a trade or business, 2) the trade or business must be regularly carried on, and 3) the activity must be substantially unrelated to the organization's exempt purpose.<sup>22</sup>

## III. WHEN DOES AN ACTIVITY CONSTITUTE A TRADE OR BUSINESS?

The term trade or business has been defined and interpreted in a number of ways over the years by the Internal Revenue Service ("IRS") and the courts. In particular, the term trade or business represents "any activity which is carried on for production of income from the sale of goods or the performance of services that is not substantially related to the exempt purpose or mission of the organiza

<sup>19</sup> Rev. Rul. 73-105, 1973-1 C.B. 263.

<sup>20</sup> The changes did not impact unrelated business income tax in a significant way. See Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978); Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>21</sup> Treas. Reg. § 1.501(c)(3)(b) (1961).

<sup>22</sup> 1.R.C. §§ 512(a)(1), 513(a) (1954).

tion.”<sup>23</sup> On the other hand, the mere fact that an activity is the integral part of a large scope of activity will not cause the income from such trade or business to be exempt from taxation. Accordingly, the IRS is compelled to analyze the component parts of the larger mass of activities to determine if a trade or business does exist.<sup>24</sup>

In *Higgins v. Commissioner*,<sup>25</sup> the Court ruled that each case raising the question of what constitutes a trade or business must be evaluated and examined against four criteria: 1) intent to make a profit, 2) substantial activity over a substantial period of time, 3) the date activity commenced, and 4) whether or not the organization represented itself to be engaged in the selling of goods and services. For example, if a religious organization or church, in the interest of promoting its exempt religious purpose, sells calendars with a picture of the church and abbreviated expressions of its doctrine on the monthly leaflets to educate its members in order to share its theology with others who might purchase the calendar, the income derived from such activity is tax exempt. Conversely, the regular sale of a dietary product to the general public would not exempt the income from taxation since the sale has the essential features of a commercial endeavor.<sup>26</sup> An often referred to example of activity falling outside of the zone of *commercial manner* are permissible bingo games sanctioned under state law.<sup>27</sup>

Factors which must be evaluated to determine whether the commercial manner exists include: 1) profit making and accumulation of profits, 2) competition with for-profit entities, 3) extensive expansion efforts, and 4) formal contract relationship.<sup>28</sup> Another factor which has evoked much debate and evaluation is that of unfair competition. Although often qualitatively important, it does not have to be present for an activity to be considered a trade or business. The language of the Code classifies *any* activity resulting in the production of income as a trade or business.<sup>29</sup> In *Carolina Farm & Power Equipment Dealers Association, Incorporated v. United States*,<sup>30</sup> taxable income was found to exist where revenue, a seven percent royalty, was gener

<sup>23</sup> I.R.C. §§ 513(a)(1), (c) (1954).

<sup>24</sup> I.R.C. § 513(c) (1954); Treas. Reg. § 1.513-1(b) (1970).

<sup>25</sup> 312 U.S. 212 (1941).

<sup>26</sup> Treas. Reg. § 1.513-5(b) (1970); Rev. Rul. 73-24, 1973-2 C.B. 190.

<sup>27</sup> I.R.C. § 513(1954).

<sup>28</sup> Buzzard & Buzzard, *supra* note 1, at 40.

<sup>29</sup> I.R.C. § 513(c) (1954). *See also* Clarence LaBelle Post No. 217 v. U.S., 580 F.2d 270 (5th Cir. 1978); American Bar Endowment v. U.S., 477 U.S. 105 (1986); Louisiana Credit Union League v. U.S., 501 F. Supp. 934 (E.D. La. 1980), *affd*, 693 F.2d 525 (5th Cir. 1982).

<sup>30</sup> 699 F.2d 167 (4th Cir. 1983).

ated for the exempt organization through facilitating the sale of insurance to its members. In a similar case, the court also found unrelated income to exist when various novelties were sold to donors after the contributions were paid.<sup>31</sup> Alternatively, in *Hope School v. United States*,<sup>32</sup> the court held the mailing of greeting cards to potential contributors, some of whom ultimately made contributions, did *not* cause the activity to be classified as a trade or business.

Finally, the Code and its regulations, under the aegis of the *fragmentation rule*, provide that when activities are covered within a larger scope of activity of an exempt organization the part not substantially related to the organization's exempt purpose retains its identity as a trade or business.<sup>33</sup> For example, although a tax exempt entity provided mailing services for other organizations as an integral part of its overall mailing operations encompassing its own exempt activity, providing the service to other organizations triggered the application of unrelated business income tax.<sup>34</sup> Furthermore, when a tax exempt museum sold scientific books and souvenirs of the city to the public along with other items compatible with its exempt purpose, the sale of the scientific books and souvenirs resulted in the application of unrelated business income tax.<sup>35</sup> These activities were considered to be an integral part of the whole and were taxable under the fragmentation rule as well.

#### IV. WHEN IS AN ACTIVITY DEEMED TO BE REGULARLY CARRIED ON?

In order for any activity or enterprise of any religious organization or church to be subject to the Unrelated Business Income Tax ("UBIT"), it must be regularly carried on.<sup>36</sup> The applicable test is to evaluate the "frequency and continuity with which the activities are conducted and the manner in which they are pursued."<sup>37</sup> The purpose of the business activity being conducted by the exempt organization must be placed on a similar or equal footing with a taxable business enterprise with which there is apparent competition.<sup>38</sup> For example, the

<sup>31</sup> *Disabled American Veterans v. U.S.*, 650 F.2d 1178 (Ct. Cl.

<sup>32</sup> 612 F.2d 298 (7th Cir. 1980).

<sup>33</sup> I.R.C. § 513(c) (1954).

<sup>34</sup> Rev. Rul. 68-550, 1968-2 C.B. 249.

<sup>35</sup> Rev. Rul 73-105, 1973-1 C.B. 263.

<sup>36</sup> I.R.C. § 512(a) (1954).

<sup>37</sup> Treas. Reg. § 1.513-KcKl) (1968).

<sup>38</sup> RICHARD R. HAMMAR, PASTOR, CHURCH AND LAW 780 (2d ed. 1991).

one-time production and promotion of a circus has been deemed by the IRS to be irregular and not subject to taxation.<sup>39</sup> Alternatively, a similar one-time activity involving the construction and selling of eighty homes over an eighteen month period has been determined to be regularly carried on and subject to taxation.<sup>40</sup>

Often religious organizations and churches have annual events or fundraisers to generate revenue for their operational needs. These annual events are generally not considered to be regularly carried on and subject to taxation.<sup>41</sup> However, the outcome would be different if the promotion endeavor is extensive and solicitations are made to the public. For example, the sale of annual advertisements in a yearbook, using an outside contractor to promote and acquire the advertisements, would result in the monies received being subject to taxation since the activity compares to a typical commercial endeavor.<sup>42</sup>

Even if the activity is intermittent or seasonal, but competes with a normal tax paying entity, the activity is nonetheless regularly carried on and subject to taxation.<sup>43</sup> For example, the operation of a commercial parking lot for one day each week, on a year-round basis, is considered to be regularly carried on and consequently the income from this activity is taxable.<sup>44</sup> On the other hand, the operation of a booth by a religious organization for a two week period at a state fair would *not* trigger the application of UBIT.<sup>45</sup>

An unusual application of unrelated business income tax was the holding of the Tenth Circuit Court of Appeals that revenue received by the NCAA from the advertising and sale of its "Final Four program" by a third party contractor does not impute UBIT to the NCAA.<sup>46</sup> In countering the foregoing decision, the IRS maintains solicited advertisements made by volunteers for a published directory every two or three years, despite meeting the informational needs of its members and consistency with its exempt purpose, was nevertheless too frequent and regularly carried on.<sup>47</sup>

Finally, if a church or religious organization were to sell Christmas cards and trees every year, the activity would be classified as regularly carried on and therefore taxable.<sup>48</sup> The basis for the conclusion is

<sup>39</sup> Priv. Ltr. Rul. 80-33-017 (Apr. 29, 1980).

<sup>40</sup> Rev. Rul. 55-449, 1955-2 C.B. 99.

<sup>41</sup> Treas. Reg. § 1.513-1(c)(iii) (1968).

<sup>42</sup> Rev. Rul. 73-424, 1973-2 C.B. 190.

<sup>43</sup> Treas. Reg. § 1.513-1(c)(2)(i) (1968).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Nat'l Collegiate Athletic Assoc. v. Comm'r Int. Rev., 914 F.2d 1417 (10th Cir. 1990).

<sup>47</sup> Priv. Ltr. Rul. 93-02-035 (Oct. 23, 1992).

<sup>48</sup> Veterans of Foreign Wars Dept. of Michigan v. Comm'n, 89 T.C. 7 (1987).

the activity undertaken was seasonal in nature and in direct competition with for-profit entities. Alternatively, the selling of advertising by a tax exempt symphony for its annual program book was not deemed to be regularly carried on.<sup>49</sup>

#### V. WHEN IS AN ACTIVITY DEEMED TO BE SUBSTANTIALLY RELATED?

An activity is deemed to be substantially related to the purpose of a tax exempt entity if the activity in question has a significant and direct relationship toward the fulfillment of the exempt purpose.<sup>50</sup> Thus, for an activity to be substantially related, it must contribute significantly to the exempt purpose of the organization.<sup>61</sup> For example, if a religious organization established a halfway-house for recovering alcoholics who were just released from a treatment center, and had, as a component, an on-the-job work requirement for the purpose of developing self-discipline and sound work habits, the activity would be significantly related and therefore not subject to taxation.<sup>62</sup> In another pertinent case, the IRS held that an exempt church's proposal to operate a birthing center where pregnant women could participate in prenatal classes would not result in unrelated business income tax. The rationale of the IRS was that the church was perpetuating its religious belief through such activity.<sup>63</sup>

On the other hand, a number of activities are not considered substantially related. In *Iowa State University of Science and Technology v. United States*,<sup>64</sup> the Court of Claims held that a state university's operation of a radio and television focused on commercial activity for the purpose of profit maximization, and not on the educational needs of the students, and thus was not substantially related to the university's tax exempt purpose. On another occasion, the IRS has held that a university's sale of computer time to the public was also an unrelated activity and therefore the revenue generated from the activity was taxable.<sup>65</sup>

In further evaluating whether or not an activity is substantially related, the IRS routinely considers several factors such as the size

49. Rev. Rul. 75-201,1975-1 C.B. 164.

50. Rev. Rul. 75-201,1975-1 C.B. 164.

51. Treas. Reg. § 1.513-1(d)(2) (1967).

52. Rev. Rul. 75-476,1972-2 C.B. 208.

<sup>53</sup> Priv. Ltr. Rul. 92-52-037 (Oct. 8,1992).

<sup>54</sup> 500 F.2d 508 (Ct. Cl. 1974).

<sup>55</sup> Priv. Ltr. Rul. 79-02-019 (Sept. 29,1978).

and extent of the activity and whether or not such activity contributes to the accomplishment of the exempt purpose.<sup>56</sup> Therefore, if any income-producing activity is to remain exempt, it must be substantially related and only be operated on a scale essential to provide a causal relationship.<sup>57</sup>

In *Orange County Agricultural Society v. Commissioner*<sup>58</sup> the court upheld the action of the IRS when it revoked the tax exempt status of the involved exempt organization. The basis for the revocation was that the organization generated more than one-third of its revenue from an automobile racetrack when its stated exempt purpose was to promote interest in agriculture and horticulture. In a compatible ruling, the IRS held the operation of a grocery store by an exempt organization for the purpose of providing therapeutic training for emotionally disturbed youth, even though the grocery store was almost fully staffed by the youth, was excessive in scope and on a larger scale than necessary for the performance of the exempt purpose.<sup>59</sup>

In the 1969 Revenue Act, Congress confirmed that the sale of religious articles in connection with a church does not result in unrelated business income tax.<sup>60</sup> For example, the sale of a pamphlet outlining the religious doctrine of the church would *not* be taxable, nor would the sale of an interpretative Bible outlining the scripture result in the application of tax. However, if an item is sold, for example a watch, which has no religious character, the transaction would be taxable.

Finally, numerous sales of items resulting from the performance of the tax exempt functions of various organizations occur. Gross income derived from such activities does not result in taxation.<sup>61</sup> For example, if a church operates a tax exempt rehabilitation program which includes the sale of items produced by trainee workers in its *sheltered workshop*, the sale of such items would *not* trigger the application of UBIT.<sup>62</sup> Other exempt examples include the sale of milk taken from an experimental dairy herd by an exempt research organization,<sup>63</sup> the sale of homes by students enrolled in a vocational training program,<sup>64</sup> and the sale of electrical circuitry through a rehabilitation program for epileptics.<sup>65</sup>

<sup>56</sup> Treas. Reg. § 1.513-1(d)(2) (1968).

<sup>57</sup> Treas. Reg. § 1.513-1(d)(3) (1968).

<sup>58</sup> 893 F.2d 647 (2d Cir. 1990).

<sup>59</sup> Rev. Rul. 76-94, 1976-1 C.B. 171.

<sup>60</sup> S. REP. No. 91-552, 91st Cong., 1st Sess. 70 (1969).

<sup>61</sup> Treas. Reg. § 1.513-1(d)(4)(i) (1968).

<sup>62</sup> Treas. Reg. § 1.513-1(d)(4)(ii) (1968).

<sup>63</sup> *Id.*

<sup>64</sup> Rev. Rul. 76-37, 1976-1 C.B. 148.

<sup>65</sup> Priv. Ltr. Rul. 81-09-037 (Dec. 4, 1980).

Conversely, should a religious organization provide an open weekly public forum showing secular movies for a fee, the income derived from the activity would be subject to taxation.<sup>66</sup> The same result would occur should a religious organization offer travel tours without having any religious, educational or ecclesiastical purpose connected to such an event.<sup>67</sup> However, should a link be established between the travel and the ecclesiastical purpose, the income from such an endeavor would be tax exempt because it is substantially related.<sup>68</sup> Acting somewhat inconsistently with the established premise, the IRS held that a tree planting project operated by a religious organization lacked essential religious substance, was *not* substantially related to its exempt purpose and consequently the activity would be subject to taxation.<sup>69</sup>

Because the IRS and courts might employ a much narrower definition of religious purpose than ecclesiastical leaders and followers, certain precautions must be taken with regard to the substantially related test. The best measure to ensure proper consideration for any legitimate activity of the church is to cite appropriate scripture in support of the activity in the minutes and other publications related to the endeavors. This approach will invoke the separation of church and state principle embedded in the First Amendment and constitute a proper statement as to its religious tax exempt purpose.<sup>70</sup>

## VI. STATUTORY EXCLUSIONS FROM UNRELATED BUSINESS INCOME TAX

The Internal Revenue Code also provides numerous exclusions from the definition of unrelated business income tax. If an activity falls within one of these exclusions, the income from such activity is exempt from taxation, regardless of whether or not the activity is *trade or business* or *regularly carried on* or even *substantially related* to the exempt purpose of the organization.<sup>71</sup> Although numerous categories of exclusion exist, only four have specific application or are of primary interest to churches and religious organizations. Sections 512(b) and 513(a) of the Code expressly state that unrelated business income does *not* include: 1) income from volunteer activities, 2) income from activities

66. Treas. Reg. § 1.513-1(d)(4)(iii) (1968).

67. Rev. Rul. 78-43, 1978-1 C.B. 164.

68. Priv. Ltr. Rul. 81-15-025 (Jan).

69. Rev. Rul. 76-341, 1976-2 C.B. 307.

<sup>70</sup> Buzzard & Buzzard, *supra* note 1, at 48.

<sup>71</sup> *Id.* at 49.

engaged in for the convenience of members, 3) income from the sale of donated merchandise, and 4) income from qualified bingo games.<sup>72</sup>

#### A. VOLUNTEER ACTIVITIES

Income generated from the work efforts of volunteers is generally *not* subject to unrelated business income.<sup>73</sup> As long as substantially all of the work is performed by uncompensated volunteers, none of the income from such an enterprise would be subject to taxation. For example, income from a church raffle conducted by volunteers, and income from the publication of a cookbook published by volunteers would not be subject to taxation.<sup>74</sup>

In particular, the IRS has held that where a church improves property by building houses on the property largely with the assistance of volunteer labor, and subsequently sells the improved property to raise funds for the church, the income generated from such activity would not be characterized as unrelated business income tax because substantially all labor was provided by volunteers.<sup>75</sup> Further, the courts have held that income received by a religious organization from the operation of a farm where the volunteers took a vow of poverty would not result in taxation.<sup>76</sup> In a case of somewhat comparable circumstances, the court held that providing room and board to volunteers was ample compensation to nullify the application of the volunteer exclusion and make the transaction taxable.<sup>77</sup>

#### B. CONVENIENCE OF MEMBER

In accordance with Section 513(a)(2) of the Internal Revenue Code, this exclusion applies to activities which are primarily for the convenience of members, students, patients, officers, employees, and other persons directly involved with the exempt organization's mission. For example, income derived from a cafeteria operated for the benefit of the employees of the organization would *not* result in taxation.<sup>78</sup>

<sup>72</sup>1.R.C. §§ 512(b) & 513(a) (1954).

<sup>73</sup>1.R.C. § 513(a) (1954); Treas. Reg. § 1.513-1(e) (1968).

<sup>74</sup> *Id.*

<sup>75</sup> Priv. Ltr. Rul. 83-443-101 (July 28, 1993).

<sup>76</sup> *St. Joseph's Farms of Indiana Brothers of the Congregation of the Holy Cross v. Comm'n*, 85 T.C. 9 (1985).

<sup>77</sup> *Shiloh Youth Revival Centers v. Comm'n*, 88 T.C. 79 (1987).

<sup>78</sup> Rev. Rul. 69-268, 1969-1 C.B. 160.

Other examples of activities considered to be primarily for the convenience of members or employers would include gift shops and parking lots,<sup>79</sup> a laundry operated primarily to provide services to students and faculty and not operated for profit or to compete with other laundry services,<sup>80</sup> and vending machines used by members, students, faculty or staff at an exempt religious institution.<sup>81</sup> Conversely, these exclusions would *not* apply where public use is invited and/or permitted.<sup>82</sup> Not all activities in which members enjoy some benefits are covered by the exclusion rules. In *Schoger Foundation v. Commissioner*<sup>83</sup> the Tax Court found that an organization which owned and operated a lodge as a religious retreat did *not* qualify for exclusion since the activities were primarily social and recreational and were *not* regularly scheduled or required as religious activity.

#### C. SALES OF DONATED MERCHANDISE

Income received from the sales of merchandise which has been donated to a tax exempt entity is generally not subject to unrelated business income tax.<sup>84</sup> Solicited new or used goods are also considered donations and are classified as merchandise.<sup>85</sup> This exclusion was written into the Code in order to exempt thrift shops from taxation.<sup>86</sup> However, if the donated merchandise undergoes substantial refurbishment before the sale, with such refinements being performed by persons other than volunteers, the application of unrelated business income tax is highly probable.

In line with this reasoning, the IRS will find the income from rummage sales, charity book sales and similar events to be exempt from taxation. However, where an exempt organization sponsors the operation of a commercially-owned thrift shop for a fee, the exemption from taxation would not apply. In order for the exemption to be valid, the exempt organization must conduct the operation of the involved enterprise.<sup>87</sup> The requirement is the result of unclear IRS regulations

79. Rev. Rul. 69-267, 1969-1 C.B. 160.

<sup>80</sup> Treas. Reg. § 1.513-1(e)(2) (1968).

<sup>81</sup> Priv. Ltr. Rul. 78-38-108 (June 23, 1978).

<sup>82</sup> Rev. Rul. 81-19, 1981-3 C.B. 10.

<sup>83</sup> 76 T.C. 380 (1981).

<sup>84</sup> Gammon & Strange, P.C., *Entrepreneurial Activity a UBIT Premier for Nonprofits*, NONPROFIT ALERT 9110-1 (2d ed. 1994) (on file with journal)

<sup>85</sup> Treas. Reg. § 1.513-1(e) (1968).

<sup>86</sup> S. REP. No. 2375, 81st Cong., 2d Sess. 483 (1950).

<sup>87</sup> Priv. Ltr. Rul. 80-41-007 (May 3, 1980).

as to whether or not actual operation is essential. The final chapter of the unfolding scenario is yet to come.

#### D. BINGO GAMES

In recent years, a number of tax exempt religious organizations have operated and continue to operate bingo games on a regular basis. Section 513(f) of the Code specifically excludes bingo games sponsored by churches from the definition of an unrelated trade or business, provided three conditions are met: 1) they are not operated in violation of state or local law; 2) they are not conducted or carried out on a commercial basis; and 3) wagers are placed, winners are determined and prizes are distributed in the presence of all persons placing wagers.<sup>88</sup>

Bingo games are defined as games of chance which are played with cards generally containing five rows of five squares. Therefore games such as keno, dice, card and lottery are not exempt.<sup>89</sup> To be in compliance with state or local law, the bingo games and associated work efforts should be provided by volunteers. Moreover, the bingo games cannot compete with similar games which are commercial and/or conducted for profit.<sup>90</sup>

#### VII. PASSIVE INCOME

With the passage of the Revenue Act of 1950, Congress enacted several exclusions from unrelated business income tax principally impacting churches and religious organizations. Those exclusions include income in the form of dividends, interest and annuities, and royalties as well as capital gains and losses from the sale of real and personal property.<sup>91</sup> The logic behind the exclusion is that the receipt of passive income usually does not involve an active role in a trade or business and is usually not endowed with the features of competitiveness associated with a for-profit business entity.<sup>92</sup> Therefore, if an exempt religious organization sells real property which results in a capital gain, its income is not subject to UBIT. However, if the gain or loss of profit results from the sale of a customary inventory item associated with the usual and consistent operation of a business entity, the

<sup>88</sup>1.R.C. § 513(f) (1984).

<sup>89</sup>Treas. Reg. § 1.513-5(d) (1969).

<sup>90</sup>1.R.C. § 513(f)(2)(b), (c) (1969); Treas. Reg. § 1.513-5(c)(3) (1970).

<sup>91</sup>1.R.C. § 512(b) (1954); S. REP. No. 2375, 81st Cong., 2d Sess. 483 (1950).

<sup>92</sup>S. REP. No. 2375, 81st Cong., 2d Sess. 20-31 (1950).

income is taxable. For example, the routine sale of religious tapes or books from the church book store to the general public may result in the application of unrelated business income tax.

Rental property, while enjoying the routine exclusion from unrelated business income tax, may be subject to taxation if any of the following conditions exist: 1) it is debt-financed (acquired through debt obligation); or 2) rent is received from a controlled organization (80% ownership of a related entity); or 3) the amount of rent is determined in whole or in part on the basis of the net income or profits of the lessee. Accordingly, the rent may be based on a percentage of the gross receipts or sales without creating exposure to taxation.<sup>93</sup> For example, if a church which owns rental property and rents the excess capacity for a fixed amount of rent, such as four hundred dollars a month, none of the income would be taxable.

Further, the rental of real property along with the provision of services, poses a significant problem for churches and religious organizations in terms of the operational limitations for the purpose of avoiding taxation. Thus, services rendered for the convenience of the lessee such as maid service and daily room cleaning will cause the income from the rental activity to be taxable. However, an exception from the imposition of taxation exists where the services are related to rental income derived from the operation of a hotel, parking lot, tourist camp, motel, warehouse and storage garage. This income is not characterized as rental income from real property. In the alternative, income from the rental of a residence or office space is considered rental income.<sup>94</sup>

The rule with respect to the providing of services has been rationally evaluated by the IRS on the basis of the situation. In one case, the IRS determined rental income derived from the periodic rental of an exempt organization's meeting hall, which included the providing of utilities and janitorial services, was not subject to taxation. The rationale was based on the modest time of rental periods.<sup>95</sup> Therefore, the caution to religious organizations is to "use fixed rents, avoid debt-financed property, and minimize any personal services associated with the rental."<sup>96</sup>

Interestingly, the rental income of personal property is exempt from taxation only if it is incidental to, and connected with, the rental of real property.<sup>97</sup> The rental of personal property is subject to taxa

<sup>93</sup>1.R.C. § 512(b)(3)(BXii) (1954); Treas. Reg. § 1.856-4 (1976).

<sup>94</sup> Treas. Reg. § 1.512(b)-1(cX5) (1970).

<sup>95</sup>Rev. Rul. 69-178, 1969-1 C.B. 158 (1969).

<sup>96</sup> Buzzard & Buzzard, *supra* note 1, at 57.

<sup>97</sup>1.R.C. § 512(b)(3)(AXi) (1954).

tion unless it is rented with real property and the amount of income from the personal property rental is ten percent or less than the total amount of income. Moreover, if the personal property generates fifty percent or more of the total rental income when both real and personal property are involved in the transaction, the income on both real and personal property is subject to taxation.<sup>98</sup> For example, if total rent from real and personal property related to the leasing of excess office space is ten thousand dollars and the amount specified for personal property is five hundred dollars, there would be no taxation. In another illustrative example, if six thousand dollars of the ten thousand dollars rental income was designated for personal property, the entire amount of rental income would be subject to taxation. "Dividends and interest . . . are excluded from the base of tax on unrelated income because they are 'passive' in character and are not likely to result in serious competition with taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts."<sup>99</sup>

Finally, royalty income routinely has been excluded from taxation under the characterization of passive income.<sup>100</sup> Without any expressed definition of royalty in the Code, its meaning has evolved by court and IRS decisions which have not always been consistent. In *United States Universal Joints Company v. Commissioner*,<sup>101</sup> the court defined a royalty as payment which is received in return for permission to use the property loaned and is usually payable in proportion to use.

Further, in a significant revenue ruling, the IRS defined royalty as "funds that an organization receives for the use of trademarks, service marks, or copyrights, whether or not the payment is based on the use made of such property."<sup>102</sup> Accordingly, any payment made for the performance of personal services does not fall within the definition of a royalty.<sup>103</sup> For example, if a church or religious organization receives income from the sale of a book or other publication not related to its exempt purpose, the income would be taxable. On the other hand, if the book or publication were transferred to an outside source for commercial development and sold under a royalty contract, the

<sup>98</sup> Treas. Reg. § 1.512(b)-1(c)(2)(ii), (iv) (1970).

<sup>99</sup> S. REP. No. 2375, 81st Cong., 2d Sess. 483 (1950).

<sup>100</sup> 1.R.C. § 512(b)(2) (1954).

<sup>101</sup> 46 B.T.A. 111 (1942).

<sup>102</sup> Rev. Rul. 81-178, 1981-2 C.B. 135.

<sup>103</sup> *Id.*

income received by the church or religious organization would not be subject to taxation.

## VI. DEBT-FINANCED PROPERTY

Debt-financed property was operated freely prior to 1950. Exempt organizations did not have to account for or be subject to taxation on investment income resulting from the ownership of such property. Due to concerns and actual abuses, Congress initiated the taxation of debt-financed real property with the passage of the Revenue Act of 1950. However, the abuses were not completely terminated as a result of this law, and tax exempt organizations continued to embrace numerous questionable transactions. In particular, the case of *Commissioner v. Clay Brown*<sup>104</sup> increased awareness. In this case, a not-for-profit entity purchased a saw and lumber mill operation for 2.2 million dollars with very little cash and leased the assets back to a new company organized by a former shareholder of the seller who agreed to pay the exempt organization eighty percent of the new company's operating profits. In return, the not-for-profit organization agreed to funnel ninety percent of the payment to amortize the unpaid amount on the non-interest bearing note associated with the purchase arrangement. The United States Supreme Court sustained the propriety of the transactions, and Congress was forced to act by passing additional legislation.<sup>105</sup>

In response to these continuing abuses, Congress expanded the provisions of the Code's Section 514 to impose taxation on passive activity to the extent income is generated by debt-financed property. Section 514 of the Code defines debt-financed property as "any property held by an exempt organization for the purpose of generating income and for which there exists an acquisition indebtedness, such as a mortgage, at any time during the course of the organization's tax year."<sup>106</sup> Organization indebtedness is defined as: 1) the acquisition indebtedness incurred by the organization to acquire or improve the property;<sup>107</sup> 2) the indebtedness incurred before any acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement;<sup>108</sup> and 3) the indebtedness incurred after the acquisition or improvement of such

104. 380 U.S. 563 (1965).

<sup>105</sup> S. Rep. No. 91-552, 91st Cong., 1st Sess. 423 (1969).

106. I.R.C. § 514(b)(1) (1954). See also HAMMAR, *supra* note 38, at 783

107. I.R.C. § 514(c)(1)(A) (1954).

<sup>108</sup> I.R.C. § 514(c)(1)(B) (1954).

property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.<sup>109</sup>

The definition of acquisition indebtedness will apply not only when funds are used directly for the purchase of property, but also in instances when funds are borrowed which otherwise would not have been, except for the acquisition of property. Accordingly, the bottom line is not whether or not the funds borrowed were used for the particular acquisition, but whether or not the acquisition caused the borrowing of funds before or after the purchase.<sup>110</sup>

#### A. EXCEPTIONS TO DEBT-FINANCING RULES

Section 514 of the Code provides several exceptions to the definition of debt-financed property.

##### 1. Substantially Related Property

If all of the property is substantially used, eighty-five percent or more, in the fulfillment of the exempt purpose of the organization, the income from such property is exempt from taxation as debt-financed income.<sup>111</sup> In complying with the criteria, a religious organization must demonstrate that the degree of usage is substantial and related to the exempt purpose of the organization.<sup>112</sup> Alternatively, if the property fails to meet the eighty-five percent test, then the property is deemed to be debt-financed.<sup>113</sup> On the other hand, if the property is not used eighty-five percent of the time for exempt activity, the property is considered to only be debt-financed to the extent of nonexempt use based on time used or physical space occupied.<sup>114</sup>

##### 2. Income Already Subject To UBIT

If the income from the activity of the organization is already subject to taxation, the rules governing debt-financed property would *not* apply.<sup>115</sup> For example, if an activity involving rental activity is subject

<sup>109</sup>1.R.C. § 514(c)(1)(C) (1954).

<sup>110</sup>1.R.C. § 514(c)(1) (1954).

<sup>111</sup>1.R.C. § 514(b)(1) (1954); Treas. Reg. § 1.514(a)-1(a)(m) (1969).

<sup>112</sup>1.R.C. § 514(b)(1)(A) (1954).

<sup>113</sup>1.R.C. § 514(b)(1)(A) (1954).

<sup>114</sup>1.R.C. § 514(b)(1)(B) (1954).

<sup>115</sup>1.R.C. § 514(b)(1)(B) (1954); Treas. Reg. § 1.514(b)-1(b)(2) (1969).

to taxation, no other section covering unrelated business income tax would apply to avoid duplication of taxation.<sup>116</sup>

### 3. Property Used By Related Tax Exempt Entity

Property used by one exempt organization which is rented to another related exempt organization is not treated as debt-financed property if one of several conditions is met: 1) if one organization controls the other, for example, has a combined eighty percent of the voting power for all classes of stock;<sup>117</sup> 2) if more than fifty percent of the members are members of both organizations,<sup>118</sup> or 3) if both of the organizations are affiliated or connected with another state, national or international tax exempt entity.<sup>119</sup>

### 4. Qualifying Research Activity

Property used by an exempt organization, such as a college or hospital, which generates income does *not* result in the application of unrelated business income tax if the results of such research are made available to the public, without restrictions or limitations.<sup>120</sup> For example, research involving the use of a new dietary drug utilizing private persons with the results being made public does not result in a taxable event. However, if the research activity is operated in a commercial manner and generates income disproportionate to the size and extent of the organization's overall activities, the income from the undertaking would be taxable.

### 5. Charitable Remainder Property

Any property transferred to a trust or fund contingent to a *bona fide* contract, which provides for payment of income to some individual for a period of time not to exceed the life of the individual, renders such income exempt from unrelated business income tax. In order for the tax exemption to apply, the involved property and related transfer cannot represent a sale or exchange of the property. Further, the remainder interest, the essence of the trust, must ultimately vest ownership in a tax exempt entity.<sup>121</sup>

<sup>116</sup> I.R.C. § 514(b)(1)(B) (1954); Treas. Reg. § 1.514(b)-1(b)(4) (1969)

<sup>117</sup> Treas. Reg. § 1.512(b)-1 (1954).

<sup>118</sup> Treas. Reg. § 1.512(b)-1(e)(4) (1970).

<sup>119</sup> Treas. Reg. § 1.514(b)-1(cX2)(ii) (1969).

<sup>120</sup> I.R.C. § 514(b)(MIX8) (1954); Treas. Reg. § 1.514(b)-1(bX4) (1972).

<sup>121</sup> I.R.C. § 501(cX3) (1954); Treas. Reg. § 1.514(b)-1(c)(2)(iii) (1992).

## 6. Neighborhood Land Rule

The provisions of the Internal Revenue Code exempt from taxable income real property acquired by religious organizations, provided the property is to be used for exempt purposes within fifteen years.<sup>122</sup> Several specific conditions must be met before the exemption is applicable. First, the land must be contiguous to other property owned and used for exempt activity by the involved religious organization.<sup>123</sup> Intervening streets, bridges, roads, streams, railroads and other similar dividers represent an exception to the contiguous requirement and do *not* prevent application of the exemption.<sup>124</sup> Second, the new land acquired must be within one mile of other property used by the religious organization, provided no other land is available in the neighborhood.<sup>125</sup> Third, any building existing on the newly acquired real property must be demolished or removed within fifteen years after acquisition with such demolition or removal being a part of the religious organization's plan of usage.<sup>126</sup> Further, any construction on the land must be for exempt purpose usage.<sup>127</sup> If other activity is involved, the property should be properly characterized as debt-financed and subject to unrelated business income tax.<sup>128</sup> Finally, the religious organization must demonstrate by a definite plan the details for land improvement, a completion date, and affirmative action toward fulfillment of the plan, by submitting such a plan to the IRS within ninety days before the expiration of the fifth year after the new property is acquired.<sup>129</sup>

## 7. Income from Specific Activities

The activities engaged in by religious organizations are broad. These activities present some specifics which require appropriate discussion to determine whether unrelated business income should apply.

### *a. Real Property Leases*

Religious organizations commonly lease excess real property to generate revenue. If the real property is not leased or rented to a con

<sup>122</sup>Treas. Reg. § 1.514(b)-1(e)(1) (1972).

<sup>123</sup>Treas. Reg. § 1.514(b)-1(d)(1) (1972).

<sup>124</sup>Treas. Reg. § 1.514(b)-1(d)(1)(ii) (1972).

<sup>125</sup>Treas. Reg. § 1.514(b)-1(d)(1)(ii) (1972).

<sup>126</sup>1.R.C. § 514(b)(3)(c)(i) (1976); Treas. Reg. § 1.514(b)-1(d)(3Xi)(a) (1976).

<sup>127</sup>*Id.*

<sup>128</sup>Treas. Reg. § 1.514(b)-1(d)(3) (1972).

<sup>129</sup>Treas. Reg. § 1.514(b)-1(d)(1)(iii) (1972).

trolled subsidiary, or is not debt-financed, the income generated from the rental activity is considered to be passive income and *not* subject to taxation as UBIT. For example, if a church were to rent its unoccupied and debt-free parsonage to an unrelated, non-profit organization, the income would not be taxable. Furthermore, the rental of college rooms during the summer by a Christian school would yield a similar positive conclusion, unless services such as cleaning and maintenance of the rooms and related accommodation services are provided.<sup>130</sup>

*b. Parking Lot Rental*

The rental of the entire parking lot on a fixed or percentage income basis by the religious organization would *not* pose any taxation problems, nor would the rental of individual spaces or a fraction of the total lot create a taxable event.<sup>131</sup> However, if the parking lot is rented under either example with the religious organization providing the lot attendant and other services, the income would be characterized as unrelated business income tax.<sup>132</sup> For example, if a church were to rent the space on its parking lot during non-church hours without any services provided, none of the income would be taxable.

*c. Child Care Services*

This particular activity is of critical importance to religious organizations, because they provide services on behalf of children. Some religious organizations provide child care during which the content is focused on religion. Others provide this service to the general public without the religious content or where the financial need of the student or parents is not a factor material to the child's enrollment. There is high probability that child care facility income is taxable if no general community or public need is being met.<sup>133</sup> Accordingly, if a church wishes to avoid taxation, it should be certain to have the child care program inclusive of substantial religious content.

*d. Income from Insurance Programs*

Religious organizations usually generate income from insurance programs through two methods. One is through the permitted usage of

<sup>130</sup>Treas. Reg. § 1.512(b)-1(c)(5) (1969).

<sup>131</sup>Priv. Ltr. Rul. 84-45-005 (July 11, 1984).

<sup>132</sup>*Id.* See also Priv. Ltr. Rul. 89-04-002 (Oct. 24, 1988).

<sup>133</sup>Priv. Ltr. Rul. 80-45-013 (July 31, 1980).

the organization's name which results in royalty income, and would pose no tax consequence. As previously explained, royalty income is characterized as passive income which, because it results from no competition with commercial enterprise, does not result in the application of unrelated business income tax.<sup>134</sup> The other method results from the religious organization being an *insurer*, and operating precisely like a commercial insurance enterprise. When this happens, the religious organization naturally assumes all the risks associated with the business enterprise and in return has the expectation of profit.<sup>136</sup>

This concept of insurer is distinctly commercial in character and does result in unrelated business income tax.<sup>136</sup> For example, if the church contracts with an insurer and serves as administrator of the insurance program, receiving a percentage of the premium for such service, the revenue generated from such activity is unrelated business income.<sup>137</sup>

Insurer activity is subject to two exceptions for religious organizations. First, no taxation would result where property and casualty insurance is provided for a church or association of churches.<sup>138</sup> Second, the operation of retirement and welfare plans under the control of the church intended to benefit employees or their beneficiaries would not trigger a taxable event.

#### *e. Sales of Goods*

The sale of goods by religious organizations has posed a significant problem for tax enforcement officials. However, the legislative history is very clear. The printing, distribution, and sale of religious articles and material with a substantial religious content carried on in connection with the operation of the religious organizations for the benefit of members clearly does *not* result in taxation.<sup>139</sup> Thus, income generated from the sale of religious tracts, pamphlets, calendars, books, magazines and other products result in non-taxable income.<sup>140</sup>

Conversely, the sale of goods resulting from the operation of a bookstore present the prospects for a somewhat different conclusion. If the religious organization operates the bookstore or gift shop for

<sup>134</sup> I.R.C. § 512(b)(2) (1954).

<sup>135</sup> I.R.C. § 501(m) (1954).

<sup>136</sup> *Id.*

<sup>137</sup> Priv. Ltr. Rul. 94-41-001 (Aug. 9, 1993).

<sup>138</sup> See *American Bar Endowment v. U.S.*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd sub nom. on other grounds and remanded*, *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986).

<sup>139</sup> S. REP. No. 552, 91st Cong., 1st Sess. 69 (1969).

<sup>140</sup> Priv. Ltr. Rul. 79-19-034 (Feb. 7, 1979).

members and the public on a full-time operational basis, the income would be characterized as unrelated business income. However, should the operation be limited to the purpose of the religious organization and sales of religious and secular products and goods is made to the members and the public, the non-religious products would be characterized on an individual basis<sup>141</sup> for determination in the fulfillment of the exempt purpose of the organization. Accordingly, those items not related would be taxed under the aegis of unrelated business income tax.

*f. Publication Sales*

The income generated by a religious organization from publication sales is exempt, provided four (4) criteria are met: 1) the publication must be educational; 2) preparation of the publication must use methods that are accepted as educational in character; 3) distribution of the publication must be necessary or important in achieving the exempt purpose; and 4) the distribution methods must be different from those of commercial publications.<sup>142</sup>

*g. Mailing Lists Rental and Sales*

In recent years, many religious organizations have come to realize the value of their mailing lists. They have routinely been offered compensation for the use of such lists by for-profit enterprises. The proponents of this kind of activity by exempt organizations have maintained that it is not a taxable event since the income would be properly classified as royalty revenue. As previously mentioned, all royalty income is exempted from taxation under Section 512(b)(2) of the Code.<sup>143</sup>

In *Disabled American Veterans v. Commissioner (DAV I)*,<sup>144</sup> the Court of Claims held such payments were *not* royalty revenue and could *not* be classified as passive income under Section 512(b) of the Code. However, Congress revisited this issue when passing the Tax Reform Act of 1986, which added subsection (h). This provision provided that UBIT was not applicable in transactions involving the rental or exchange of membership/donor lists between exempt organizations. The outcome would be to the contrary if such transactions involved a for-profit entity.<sup>145</sup> In *Disabled American Veterans v.*

141. Priv. Ltr. Rul. 86-05-002 (Sept. 4, 1985); Priv. Ltr. Rul. 80-24-111 (Jan.

<sup>142</sup> Lynn R. Buzzard, Minister's Legal Desk Reference 25 (1991).

143. Buzzard & Buzzard, *supra* note 1, at 80.

<sup>144</sup> 650 F.2d 1178 (Ct. Cl. 1981).

<sup>145</sup> Buzzard & Buzzard, *supra* note 1, at 81.

*Commissioner (DAV II)*,<sup>146</sup> the tax court held that mailing list income involving exempt entities represented excludable royalty income and resulted in no tax consequences. Accordingly, religious organizations have the freedom to exchange donor/membership lists with other tax exempt entities and avoid tax consequence.<sup>147</sup>

#### *h. Professional Events*

Religious organizations are increasingly sponsoring concerts and other forms of related ministry involvements. Since this area of religious endeavor is somewhat ill-defined from a tax standpoint, it is naturally somewhat troublesome. However, taxation can be avoided if several key guidelines are observed: 1) the event should have religious content (prayer, scripture reading, etc.); 2) any ticket sales should preferably be made at the church; and 3) the program should be represented and presented as an integral part of and/or extension of the ministry of the religious organization.<sup>148</sup>

#### *i. Cemeteries*

Income derived from this component of the religious mission is exempt from taxation, unless some other tax qualifying features are a part of the structure.<sup>149</sup>

#### *j. Affinity Programs*

Churches and religious organizations are increasingly encouraged to become involved in the area of marketing and perpetuation of their name and identity, generally through a license agreement in which the religious organization permits its name and logo to be marketed, for example, on a credit card. In return, the religious organization is paid a fee by the licensee, who routinely solicits its members from the lists provided by the religious organization. The fee paid to the church or religious organization is usually calculated on the basis of the numbers of credit cards issued, amount of credit used, or some combination of the two.

In its initial review, the IRS exempted the income from affinity activity from taxation under the characterization of it as royalty revenue.<sup>150</sup> Not too soon thereafter, however, the IRS revised its position

146. 94 T.C. 60(1990).

<sup>147</sup> Bangert, *supra* note 4, at 341.

<sup>148</sup> *Id.* at 713-14.

149. S. REP. No. 552, 91st Cong., 1st Sess. 69 (1969).

<sup>150</sup> Priv. Ltr. Rul. 87-47-066 (Aug. 28, 1986).

and concluded that the income was *not* properly classified. In *Sierra Club v. Commissioner*,<sup>162</sup> an exempt organization and a bank contracted for the marketing of an affinity credit card. Although the contract did not require the exempt entity to do so, it provided the bank with its mailing list. Thereafter, the bank assumed all the costs of production of the credit cards and related solicitation and promotional expenses. The IRS held that such income was *not* royalty income and therefore the exempt organization realized taxable income. Upon review, the tax court upheld the premise of the exempt organization that such income was excludable as royalty income. The IRS continually reviews this activity, and the final disposition on this matter is yet to come from the federal courts.

#### k. Fundraising Activities

Many religious organizations induce donors and contributors to support their ministries through incentives such as small token gifts. The Tax Reform Act of 1986 created an exemption under Section 501(c)(3) for the distribution of a *low cost article*, with a fundraising solicitation if the recipient is expressly permitted to retain the article regardless of whether he or she chooses to contribute.<sup>153</sup> A low cost article is defined as an item that costs less than \$6.20, adjusted annually for inflation. Furthermore, the statute also provides that the low cost article shall be construed as *incidental* only if: 1) such distribution is *not* made at the request of the distributee; 2) such distribution is made without the express consent of the distributee; and 3) the articles so distributed are accompanied by a request for charitable contribution to the soliciting organization and a statement that the recipients may retain a low cost item whether or not they make a contribution. By striking contrast, some religious organizations make gifts to contributors after they have donated to the ministry. These gifts include tapes, plaques, Bible markers, and other items. In *Disabled American Veterans v. United States*,<sup>154</sup> the court held that when the contribution was substantially in excess of the article's retail value, then the organization would not realize unrelated business income. Alternatively, when the contribution was not "so greatly in excess of the retail value, then the organization was engaged in a trade or business."<sup>155</sup> The IRS has produced guidelines outlining *safe*

<sup>151</sup> Priv. Ltr. Rul. 88-23-109 (Mar. 17, 1988).

<sup>152</sup> 65 T.C.M. 2582 (1993).

<sup>153</sup> I.R.C. §§ 513(h)(1)(A), (2) & (3) (1969).

<sup>154</sup> 650 F.2d 1178 (Ct. Cl. 1981).

<sup>155</sup> Buzzard & Buzzard, *supra* note 1, at

*harbors* for charities. These provisions basically provide that gifts valued at less than certain amounts will *not* result in any reductions in the deductible portion of a gift.<sup>156</sup> The regulations also provide sample statements to be included in fundraising literature.<sup>157</sup>

## IX. APPLICATION OF UNRELATED BUSINESS INCOME TAX

The most significant operational consequence a church or religious organization can face is that of tax liability. The effect of this tax liability is that all income associated with or derived from any activity considered to be a trade or business will be subject to taxation at the normal tax rate, that is, prevailing corporate tax rates. However, all organizations subject to unrelated business income tax are granted a one thousand dollar exemption on the gross receipts derived from the activity. The tax return, Form 990-T, is due on the fifteenth day of the fifth month after the close of the religious organization's tax year, usually May 15th.<sup>158</sup> The amount of gross income is the trigger for the reporting requirement. Thus, an organization would have a duty to report, by filing a Form 990-T, even if it had deductions that would otherwise reduce the gross receipts to below one thousand dollars and conceivably could result in no tax liability.<sup>159</sup>

In determining the gross receipts subject to unrelated business income tax, the organization is entitled to deduct certain revenue from the calculation equation. Specifically, income exempted from the classification as unrelated business income includes dividend income, royalty income, annuity income, capital gains and losses, and rental income from real property.<sup>160</sup>

The most significant concern regarding unrelated business income tax and its impact on religious organizations is the possible loss of the organization's tax exempt status. If the unrelated business income or gross receipts are minimal and the activity which generated the revenue is insubstantial no concern exists. However, if the activity is deemed to be substantial and the revenue is of comparable significance, the religious organization could possibly lose its tax exempt status. This devastating result can be avoided through practical planning and effective internal controls. These would prohibit

<sup>156</sup> I.R.C. § 513(b)(2) (1969).

<sup>157</sup> Rev. Proc. 90-12, 1990-6 I.R.B. 22 (amplifying Rev. Rul. 67-246, 1967-2 C.B. 104).

<sup>158</sup> Treas. Reg. § 1.6012-2(e) (1967).

<sup>159</sup> *Id.*

<sup>160</sup> I.R.C. § 512(b) (1954).

the religious organization from exceeding the safety threshold of unrelated activities and the resulting revenue generation.<sup>111</sup>

Finally, all religious organizations should operate with some rule of thumb as to the scope of unrelated business activity. If any organization is or should become involved in unrelated business activity, such activity and the corresponding revenues should be managed so as not to exceed a twenty percent threshold of the gross receipts of the total activities conducted or controlled by the religious organization.<sup>162</sup>

## **X. STRATEGIES FOR AVOIDING UNRELATED BUSINESS INCOME TAX**

Key proactive techniques that exempt organizations can take to mitigate against the exposure to unrelated business income tax include: 1) ensuring that the stated purpose in the governance documents of the organization is sufficiently expansive to include income producing/profit making activity; 2) ensuring that substantially all of the activity of the religious organization is structured to perpetuate the organization's ministry, resulting in a fairly limited window of exposure to nonexempt activity; 3) ensuring that the organization's financial structure is designed in such a way or is modified so that only a minimal amount of income may be characterized as unrelated business income;<sup>163</sup> and 4) ensuring that the structure of business transactions does not lend itself toward unrelated business income tax.<sup>164</sup>

## **XI. IRS Targets for Unrelated Business Income Tax**

Recent Congressional hearings investigating possible avoidance of UBIT by several large and well-known nonprofit organizations, including the American Association of Retired Persons and the National Rifle Association, demonstrate dramatically the increased attention that the IRS is paying such organizations. Several situations which the IRS might target for UBIT, and which religious orga

<sup>161</sup> Buzzard, *supra* note 142, at 25.

<sup>162</sup> *Id.*

<sup>163</sup> Appropriate consideration should be given to the special rules governing passive income and debt-financed income.

<sup>164</sup> For example, an organization might effectively convert business income into royalty income by having another for-profit entity engage in the business. The religious organization could grant a license to use its name in the selling of the product, and thereby escape taxation.

nizations might wish to avoid include: 1) insurance programs for members in which the religious organization performs some administrative tasks;<sup>165</sup> 2) sponsorship of sporting events by religious organizations in which its logo is used as a trade off for the sponsorship;<sup>166</sup> 3) income from the sale of advertising space in an annual publication for a charitable event which promotes commercial businesses and does not perpetuate the exempt purpose of the religious organization;<sup>167</sup> 4) interest on treasury notes purchased with borrowed funds, which would result in unrelated debt financed income;<sup>168</sup> 5) affinity programs in which the religious organization permits a financial institution to market a credit card bearing its name and/or logo, and in which the organization supports the program by providing the financial institution with its mailing list and in return financial institutions extend credit to the organization's members and markets the program;<sup>169</sup> and 6) travel tours in which no significant religious activity or religious education of ministers and/or members exists.<sup>170</sup>

## XII. Conclusion

The ebb and tide of the interaction between religious organizations and the government continues to be dynamic and somewhat unpredictable. However, there is one thing for certain, the interaction between church and state will likely remain fluid and subject to the historic pattern of a shifting and constantly changing equilibrium. This compendium has reported on the past and present relationship between religious organizations and the government, which may affect future developments of tax law in this area.

<sup>165</sup> Milton Cerny, *Mailing Lists And Affinity Card Contracts: Are They Subject To UBIT?*, Guide To Unrelated Business Income Tax (Special Report), June 1994, at 3 (on file with author).

<sup>166</sup> For example, the church's name can be put on the t-shirts of all participants in exchange for sponsoring the basketball tournament for which the attendees pay a fixed ticket price. Priv. Ltr. Rul. 92-31-001 ( \_\_\_\_\_, 1992).

<sup>167</sup> Rev. Rul. 75-201, 1973-3 C.B. 190.

<sup>168</sup> *Southwest Texas Electric Cooperative, Inc. v. Comm'r*, 68 T.C.M. 285 (1994).

<sup>169</sup> Priv. Ltr. Rul. 92-20-054 (Feb. 20, 1992).

<sup>170</sup> Such tours are suspect and are likely to be classified as commercial in nature and not related to the exempt purpose of the organization. See *International Postgraduate Medical Foundation v. Comm'n*, 56 T.C.M. 1140 (1989).