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Foundations Supporting Colleges and Universities: Unrelated Business Income Taxation

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FOUNDATIONS SUPPORTING COLLEGES AND UNIVERSITIES: UNRELATED BUSINESS INCOME TAXATION

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I. INTRODUCTION

During 1950 and 1969 Congress reacted to a growing concern over unfair competition by taxing certain activities of exempt organizations on the same basis as commercial businesses with which they competed.[1] In 1986 concern over the commercial activities of exempt organizations once again intensified as charges of "unfair competition" were directed against the exempt organizations community. Today, in view of the depth and breadth of criticism and concern, it is virtually impossible to stay abreast of all of the developments in the exempt organizations area — developments that are driven by the for-profit sector, the exempt organizations themselves, the Internal Revenue Service, the Department of the Treasury, the courts, and Congress. As a result of these events, the subject again is ripe for policy review, stricter enforcement of compliance with existing laws, and probable enactment or amendment of provisions of the Internal Revenue Code[2] and Treasury Regulations. This article

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1. The Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906 (1952), imposed a tax on exempt organizations, including state colleges and universities, in connection with the "unrelated business taxable income" derived by such organizations from any trade or business regularly carried on and not substantially related to the organization's exempt function. *See* I.R.C. §§ 511-513 (1982).

The Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1970), extended the unrelated business income tax to virtually all organizations exempt under § 501(c) of the Internal Revenue Code, including churches, but excluding § 501(c)(1) federal instrumentalities.

2. Unless otherwise provided, citations in the text and footnotes utilizing the term "section" refer to sections of the Internal Revenue Code of 1954, as amended (I.R.C.).

addresses the statutory and regulatory underpinnings of section 501(c)(3) nonprivate foundations that assist or support colleges and universities, the principles governing the unrelated business income taxation (UBIT) of these foundations, and current developments relating to UBIT.

II. Supporting Organizations

A. Entities Other Than Section 501(c)(3) Nonprivate Foundations

A number of entities, other than section 501(c)(3) organizations, support colleges and universities. A brief description of each follows.

1. Section 502 Feeder Organizations

Colleges and universities may be supported by taxable "feeder" organizations that operate for the primary purpose of carrying on a trade or business for profit.[3] These activities themselves do not constitute an exempt purpose even though all of the profits are payable to a tax-exempt organization, namely, the supported college or university.

Section 502 provides for taxation of feeder or subsidiary organizations operating primarily as a trade or business that is unrelated to the exempt activities of the parent organization. For example, if a subsidiary organization primarily furnishes electric power to consumers other than its parent organization and the parent's tax-exempt subsidiary organizations, it is nonexempt because such business would be an unrelated trade or business if carried on regularly by the parent organization.[4]

2. Section 501(c)(2) Corporations

Colleges and universities may be supported by corporations organized exclusively for holding title to property, collecting income therefrom, and turning over the income, less expenses, to an exempt section 501 organization. This type of organization

3. *See infra* note 51 and accompanying text.
4. Treas. Reg. § 1.502-1(b) (as amended in 1970).

may support only a college or university that qualifies for tax-exempt status under section 501(a).

3. *Section 501(c)(25) Corporations or Trusts*

Colleges and universities may be supported by a corporation or trust that has no more than thirty-five shareholders or beneficiaries, only one class of stock or beneficial interest, and is organized exclusively for acquiring and holding title to real property, collecting the income, and remitting the entire amount to one or more organizations that are shareholders of the corporation or beneficiaries of the trusts. Permissible beneficiaries include political subdivisions of the state, such as state universities, and section 501(c)(3) organizations.

4. *Section 501(f) Cooperative Service Organizations of Operating Educational Organizations*

Colleges and universities may be supported by Cooperative Service Organizations (CSOs) when the CSO is organized and operated solely to hold, commingle, and collectively invest money contributed by members. The CSO then collects the returns on these investments and remits them, less expenses, to its members. The CSO must be organized by, controlled by, and comprised solely of its members.[5]

5. *Section 501(c)(4) Organizations*

Section 501(c)(4) organizations conduct substantial lobbying activities for the benefit of colleges and universities that may be statutorily prohibited from engaging in lobbying or excessive lobbying. Section 501(c)(4) organizations are exempt from taxation, but contributions to such organizations are not deductible by donors.[6]

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5. Members of the CSO must be educational organizations described in § 170(b)(1)(a)(ii) or § 170(b)(1)(a)(iv) of the I.R.C. and exempt from tax under §§ 115(a) or 501(a) of the I.R.C.

6. Federal tax laws do not specifically prohibit lobbying by state universities that are § 115 organizations; such prohibition, however, may arise under state law. Use of a separate § 501(c)(4) organization may be warranted under such circumstances.

6. *Section 527(f) Political Organizations/ Separate Segregated Funds*

As with lobbying activities, no specific federal tax law prohibits political activities of section 115 organizations. States, however, usually impose statutory schemes that discourage, if not prohibit, such activities. One critical caveat must be noted: A section 501(c)(3) organization will lose that status if it establishes or uses section 527(f) political organizations/separate segregated funds for the purpose of engaging in prohibited political campaign activities.[7]

7. *Taxable Subsidiaries*

The use of taxable subsidiary corporations by section 501(c)(3) organizations has increased dramatically during the past few years.[8] By 1987-88, the use of taxable subsidiaries had become prolific.[9]

For purposes of this discussion, one may assume that the use of taxable, for-profit, wholly owned subsidiaries by many state universities either is not specifically authorized or is discouraged or prohibited. In such cases, the taxable subsidiary usually will be wholly owned by a section 501(c)(3) nonprivate foundation that supports the university. On the other hand, section 501(c)(3) colleges and universities may not be prohibited or

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7. *See* Treas. Reg. § 1.527-6(g) (as amended in 1980). *Cf.* I.R.S. Announcement 88-114, 1988-37 I.R.B. 26 (taking the position that although a § 501(c)(3) organization can establish a separate, segregated fund solely for purposes of engaging in § 527(e)(2) activities limited to influencing confirmation of judicial nominees or nominees to other nonelective public offices, the fund cannot engage in political campaign activities otherwise prohibited by § 501(c)(3)).

8. For example, the IRS issued 593 private letter rulings to I.R.C. § 501(c)(3) organizations that operated in tandem with taxable subsidiary corporations between 1977 and 1986. Of these, 435 rulings involved health care organizations, and 84 involved universities. In comparison, only eight equivalent rulings were issued in the previous ten-year period. *See* McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities — A Tax Policy Issue for 1988*, 38 TAX NOTES 1125, 1128 (1988).

9. *See* McDowell, *Using Affiliated Entities Including Title-Holding Corporations, Taxable Subsidiaries and Advocacy Groups*, 1988 REPRESENTING AND MANAGING TAX-EXEMPT ORGANIZATIONS 171, 203 (Georgetown University Law Center); *see also* Bird, NON-PROFIT ORGANIZATIONS AND TAXABLE SUBSIDIARIES, 24th Annual Washington Nonprofit Tax Conference (1988); McGovern, *supra* note 8, at 1128; Purcell, *Using For-profit Subsidiaries to Preserve Exempt Status*, 67 J. TAX'N 180 (1987).

even discouraged from establishing wholly owned, taxable subsidiaries. In those cases the college or university assumes the role of the exempt parent. In general, the subsidiary corporation owned by an exempt parent is taxed as a "C" corporation. The corporation reports its income on IRS Form 1120, and no reference is made to the subsidiary or to the parent on the respective returns filed by either entity.[10]

B. Section 501(c)(3) Nonprivate Foundations

Notwithstanding the variety of supporting organizations available to or for the benefit of colleges and universities, the section 501(c)(3) nonprivate foundation continues to provide a most attractive and effective means of generating support. Nevertheless, as one would expect, everything attractive has its price, and the burdens of compliance must be considered along with the benefits of tax-exemption.

1. Reasons for Establishing a Separate Tax-Exempt Organization

Aside from the principal purpose of providing support to the college or university, the major reason for using a section 501(c)(3) nonprivate, supporting foundation or corporation is to take advantage of the tax benefits. These benefits include: (1) exemption from federal income tax, except for the tax on unrelated business income;[11] (2) eligibility, not generally enjoyed by other tax-exempt organizations, to receive tax-deductible charitable contributions for income and estate and gift tax purposes;[12] (3) exemption from federal social security and unemployment taxes;[13] (4) miscellaneous benefits, such as special tax-deferred annuity provisions for employees[14] and postal rate priv-

10. *See infra* Appendix, at Discussion Option IX (requiring an affiliated group that includes an exempt organization to file a consolidated income return; recommending that the IRS have an integrated examination program for an exempt organization and all of its subsidiaries, whether taxable or exempt; also recommending that the IRS conduct a study to determine the use, purpose, and effect of joint ventures and taxable subsidiaries).

11. *See* I.R.C. § 501(a), (b) (1982).

12. *See* I.R.C. §§ 170, 2055, 2522 (1982 & Supp. IV 1986).

13. *See* I.R.C. §§ 3121(b)(8)(B), 3306(c)(8) (1982).

14. *See generally* I.R.C. § 403(b), (c) (Supp. IV 1986) (addressing taxation of de-

ileges;[15] and (5) the likelihood of similar exemption from various state and local taxes.

The protection of the college or university's status as a section 115 or section 501(c)(3) organization is another, and perhaps critical, reason for establishing a separate tax-exempt, supporting foundation. By establishing separate foundations, the college or university can avoid activities that later may be perceived as for-profit and/or unrelated to the exempt purposes of the institution. Therefore, such activities or contemplated activities, particularly those that may be or could become relatively large-scale operations, are placed in a separate, supporting organization in order to deflect criticism from the supported college or university.

There are several nontax reasons for establishing a separate tax-exempt, supporting foundation. These include limiting liability arising from an activity by placing it in a separate corporation and obtaining organizational, managerial, and efficiency objectives.[16]

2. *Qualification Under Section 501(c)(3)*

Charitable, educational or scientific organizations that exclusively support colleges and universities should qualify readily under section 501(c)(3). The "advancement of education or science" is included among the definitions of "charitable" under federal tax law.[17] Frequently, the IRS finds an organization to be "charitable" as well as "educational." For example, while the operation of a college or university is more educational than charitable, many satellite endeavors may be regarded as "charitable."

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ferred compensation plans for tax-exempt organizations); *see also* Gen. Couns. Mem. 39,670 (Oct. 14, 1987).

15. 39 U.S.C. § 4452(d) (1982).

16. For instance, by creating a separate fund-raising organization, a dedicated, yet independent group of prominent individuals can: (1) create a governing body of which substantial contributors can be members; (2) identify the fund-raising entity with a name that provides greater visibility and is more conducive to that of fund raising than that of the parent; and (3) avoid the bureaucratic "red tape" and administrative expenses that offset contributions and frequently chill what otherwise may be substantial contributions. Prospective donors usually are justifiably concerned that amounts paid into a political subdivision of a state may not timely reach their intended destination or may be significantly depleted by the time they do reach the intended destination.

17. *See* Treas. Reg. § 1.501(c)(3)-(1)(d)(2) (as amended in 1976).

Thus, the provision of scholarships is a charitable activity, as is the making of low-interest college loans and providing free housing, books, or supplies.[18] Fraternities and sororities, however, are not regarded as charitable or educational even though they have close operating relationships with colleges and universities.

3. *Qualification Under Section 509(a)(1)-(3): Avoiding Private Foundation Status*

Section 501(c)(3) foundations that support colleges and universities may qualify for nonprivate foundation status under section 509(a)(1)-(3). Congress enacted section 509 as part of the Tax Reform Act of 1969[19] in response to the need for greater public accountability and recognition of charitable organizations funded by a single corporation, family, or individual. This funding usually provides most, if not all, of the investment income for the organization. The private foundation typically does not conduct its own program other than making grants for charitable purposes to other persons. Stated differently, a "private foundation" is a charitable, educational, religious, literary, or scientific organization entitled to tax exemption under section 501(c)(3) but which neither receives support from a sufficient number of public sources nor is sufficiently connected to one or more "public charities" to be entitled to the benefits of public charity status.

There are four principal disadvantages that accompany private foundation status. First, under section 4940(a), a private foundation is subject to a two percent tax on net investment income, including net capital gain.[20] Second, under section 170,

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18. Other charitable activities include: publication of student journals; maintenance of a training table for athletes; provision of assistance to law students who are obtaining experience with public interest law firms and legal aid societies; operation of a foreign student center; selection of students for enrollment at foreign universities; operation of an alumni association; provision of work experience in selected trades and in professions for high school graduates and college students; the operation of interscholastic athletic programs; and the provision of housing for college students. Still other charitable, *quasi*-educational activities — such as book stores and organizations that accredit schools and colleges or provide financial and investment assistance or computer services to educational organizations — are more institutionally oriented. *See* B. HOPKINS, THE LAW OF TAX EXEMPT ORGANIZATIONS 99-100 (5th ed. 1987).

19. Pub. L. No. 91-172, 83 Stat. 487 (1970).

20. The 1984 Tax Reform Act, Pub. L. No. 98-369, § 303, 98 Stat. 494, 781-82

private foundations are disadvantaged in soliciting contributions in view of lower overall percentage limitations on deductions. Third, under chapter 42 of the Code, private foundations are subject to excise tax sanctions for: (1) self-dealing transactions;[21] (2) excessive ownership of business interest;[22] (3) investments that jeopardize charitable purposes;[23] and (4) various proscribed expenditures.[24] Section 4942 is a fifth excise tax sanction. It imposes income distribution requirements to ensure that a private foundation's disbursements bear a reasonable relationship to its endowment or income. Finally, although the Internal Revenue Service has simplified private foundation compliance somewhat, filing requirements — including publication of the availability of the annual return for public inspection — are more onerous for private foundations than for public charities.[25] Private foundation status should be avoided whenever possible in order to escape these disadvantages.

Under section 509(a), private foundation is defined by exclusion, that is, a domestic or foreign organization described in Section 501(c)(3) *other than* those specifically enumerated. Among the exclusions are three categories — public charities, membership/service organizations, and satellite organizations — that offer significant planning opportunities for tax-exempt organizations that support colleges and universities and seek to avoid private foundation status.[26]

(a) Section 509(a)(1) "Public Charities" Under Sections 170(b)(1)(A)(i)-(vi)

Of these six exceptions to private foundation status, two sections address organizations that typically support colleges and universities: section 170(b)(1)(A)(iv) and section

(codified as amended at I.R.C. § 4940(e) (Supp. II 1984 & Supp. IV 1986)), reduced the tax from two percent to one percent for a given taxable year if the five-year average amount that the foundation distributes for charitable purposes is increased by an equivalent amount.

21. *See* I.R.C. § 4941 (1982 & Supp. IV 1986).

22. *See id.* § 4943.

23. *See* I.R.C. § 4944 (1982).

24. *See* I.R.C. § 4945 (1982 & Supp. IV 1986).

25. *See id.* §§ 6033, 6104 (imposing substantial filing requirements on private foundations).

26. *See* I.R.C. § 509(a)(1)-(3) (1982).

170(b)(1)(A)(vi).[27] To qualify under either exception, the exempt organization normally must receive a substantial amount of its support[28] from governmental sources and/or contributions from the general public.[29]

(b) *Section 509(a)(2) "Membership"/"Service" Organizations*

The Tax Reform Act of 1969[30] exempted a special category consisting of certain section 501(c)(3) membership/service organizations that derive substantial support through their exempt function activities and that do not depend heavily on investment income.[31] Section 509(a)(2) requires satisfaction of both positive[32] and negative[33] support tests. Because of its support from

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27. Note, however, that the § 170(b)(1)(A)(iv) type of organization must support an agency or instrumentality of a state or political subdivision. In view of the absence of such a limitation on the § 170(b)(1)(A)(vi) exception, the latter is used much more frequently than is the § 170(b)(1)(A)(vi) organization.

28. "Support" does not include income received by the organization in the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption under § 501(a).

29. The regulations elaborate considerably upon the statutory requirements for support and establish quantitative tests based upon the relationship of governmental and public gifts to other support sources. The organization may qualify as "publicly supported" under either of two theories. First, it may qualify under a purely mathematical test, that is, when public and governmental contributions equal at least one-third of the total support received over the preceding four-year period. Second, the organization may qualify under a "facts and circumstances" determination, that is, when public and governmental contributions have equalled at least ten percent of the total support received over the preceding four-year period, provided certain relevant facts and circumstances are present. The details of certain limitations about sources of funds in determining the extent of favorable support are beyond the scope of this article.

30. Pub. L. No. 91-172, 83 Stat. 487 (1970).

31. The Boy Scouts of America, which derives substantial support through sales of uniforms and equipment, is a good example of such a membership/service organization.

32. To satisfy the positive support test, the organization must "normally" receive more than one-third of its support in each taxable year from any combination of: (1) gifts, grants, contributions, or membership fees and (2) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity that is not an unrelated trade or business, not including such receipts from any person or from any bureau or similar agency of a governmental unit in any taxable year to the extent such receipts exceed the greater of $5,000 or one percent of the organization's support in such taxable year. *See* I.R.C. § 509(a)(2)(A) (1982). Contributions or receipts from disqualified persons may not be considered as favorable support, nor may grants from private foundations that have become disqualified persons with reference to the donee. Positive support calculations generally follow a pattern established in the regulations for § 170(b)(1)(A)(vi) organizations, except that for § 509(a)(2) organizations there are the additional sources of positive support from services rendered by the organi-

"service" activities, which arguably compete with similar activities conducted by for-profit corporations, as well as statutory limitations on income from unrelated business activities, section 509(a)(2) organizations more frequently are the target of complaints regarding "unfair competition" than are other nonprivate, tax-exempt foundations.

(c) *Section 509(a)(3) "Satellite" Organizations*

The third, and usually the most desirable exclusion from private foundation status, is not "support dependent" and does not involve quantitative tests. Rather, it focuses on the *relationship* between the supporting organization and its exempt publicly supported charity or exempt membership/service organization. Basically, three statutory tests must be met for the organization to qualify and operate as a "satellite organization": (1) purpose; (2) lack of control by disqualified persons; and (3) relationship.

Purpose. A section 509(a)(3) supporting/"satellite" organization must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more organizations (the supported organization) that meet the requirements of section 509(a)(1) or (2).[34] The regulations are clear that the supporting organization is not required to pay over its income to the supported organization in order to meet the operational test. Instead, it may satisfy the test by using its income to carry on an independent activity or program that supports or benefits the specified supported organization, provided such support is limited to permissible beneficiaries.[35]

No Control by Disqualified Persons. Although the satellite or supporting organization may achieve autonomy by operating "in connection with" a public charity, it may not be controlled

zation, and no statutory provisions exist for a "facts and circumstances" approach.

33. To satisfy the negative support test, not more than one third of the organization's total support may consist of: (1) "gross investment income," consisting of interest, dividends, payments with respect to securities loans, rents, and royalties and (2) the net of unrelated business taxable income over the tax imposed by § 511.

34. If the supported organization is a college or university, it should qualify as an educational organization or a governmental unit or political subdivision of a state under § 170(b)(1)(A)(ii), (v) and, therefore, meet the requirements of § 509(a)(1).

35. *See* Treas. Reg. § 1.509(a)-(4)(e) (as amended in 1981).

"directly or indirectly" by "disqualified persons"[36] other than foundation managers and other than one or more of the supported organizations.[37] For example, if one of the supporting organization's officers is the foundation manager and is appointed by the officers, directors, trustees, or membership of the supported organization, and if the foundation manager is a "substantial contributor"/disqualified person as defined under section 4946(a)(1), such person will be regarded as a disqualified person rather than as a representative of the supported organization.[38]

Relationship. Three distinct types of relationships can exist between the supporting and supported organizations. Only one, however, must be met in order to satisfy the requirements of section 509(a)(3)(B). The supporting foundation may be: (1) operated, supervised or controlled by a publicly supported organization;[39] (2) supervised, or controlled in connection with a publicly supported organization;[40] or (3) operated in connection with a publicly supported organization.[41] Consequently, the statutory

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36. *See* I.R.C. § 4946(b) (1982 & Supp. IV 1986).

37. *See id.* § 509(a)(3)(C).

38. Treas. Reg. § 1.509(a)-(4)(j)(1) (as amended in 1981).

39. The "operated, supervised, or controlled by" relationship is the most restrictive type of relationship. It is established when a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body or officers of the supported organization. The governing body of the supporting organization need not be comprised of representatives of the supported organization for whose benefit it will be operated. A supporting organization may be "operated, supervised or controlled by" the supported organization and be operated "for the benefit of" the supported organization if the purposes of the supporting organization are carried out by the benefits afforded the supported organization. *See* Treas. Reg. § 1.509(a)-(4)(g) (as amended in 1981).

40. The "supervised or controlled in connection with" relationship may be analogized to that of brother-sister corporations. For example, there must be common supervision or control over both the supporting and supported organizations. In order to meet such requirements, the control or management of the supporting organization must be vested in the same persons who control or manage the supported organization. *See* Treas. Reg. § 1.509(a)-(4)(h) (as amended in 1981).

41. The "operated in connection with" relationship occupies two-thirds of the regulations addressing the required relationship between the supporting and supported organizations. A favorable determination will result only if the supporting organization meets two tests: the "responsiveness" test and the "integral part" test. The responsiveness test is satisfied when the supporting organization is "responsive to the needs or demands of the supported organization." *See* Treas. Reg. § 1.509(a)-(4)(i)(2) (as amended in 1981). The integral part test is met when the supporting organization maintains a "significant involvement" in the operations of the supported organization if the supported organization, in turn, is dependent upon the supporting organization for the

requirements may be met by establishing a relationship of tight control analogous to a parent-subsidiary arrangement or by providing virtual autonomy to the supporting organization.[42] Any relationship must ensure that "(i) [t]he supporting organization will be responsive to the needs of [sic] demands of one or more publicly supported organizations; and (ii) [t]he supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations."[43]

The regulations focus on the most autonomous of the three relationships between the supported and supporting organizations — the "operated in connection with" relationship — and IRS concern over this relationship grows as operation, supervision, or control by the supported organization diminishes. By the same token, however, the supporting organization typically exhibits greater concern as its autonomy lessens. Greater control by the supported organization — usually a state university or political subdivision — typically draws the supporting organization further into the "alter-ego" penumbra that the media, legislative audit councils, and other critics view with considerable skepticism.[44] The real challenge is whether the supporting organization that qualifies under section 509(a)(3), thereby avoiding the troublesome "support tests" under section 509(a)(1) and (2), can master the art of balancing the burdens and benefits of requisite control on the one hand and necessary autonomy on the other.

III. Unrelated Business Income Taxation

A. General

Laws taxing the unrelated business income of exempt organizations provide the primary means by which such organizations are held accountable for their preferred tax status. Indeed,

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type of support it provides. *See id.* § 1.509(a)-(4)(i)(3).

42. A virtually autonomous supporting organization is "operated in connection" with the supported organization for purposes of § 509(a)(3)(B).

43. Treas. Reg. § 1.509(a)-(4)(f)(3) (as amended in 1981).

44. *See, e.g.*, Provence v. Greenville Hosp. Sys. Bd. of Trustees, Slip. Op. No. 88-MO-163 (S.C. Sup. Ct., July 11, 1988) (affirmed pursuant to S.C. Sup. Ct. R. 23).

the field of unrelated business income taxation (UBIT) has received considerable attention in exempt organizations practice.[45]

Generally speaking, the operation of a trade or business as a substantial part of an exempt organization's activities is not necessarily fatal to the organization's status under section 501(c)(3) "if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513."[46] In other words, an organization will be regarded as "operated exclusively" for one or more exempt purposes if it engages *primarily* in activities that accomplish any of the exempt purposes specified in section 501(c)(3). It will not be so regarded "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[47] Even though no specific percentage limitations define what constitutes "primary" or "substantial," the IRS probably would deny or revoke tax exempt status of an organization that receives more than fifty percent of its income from an unrelated trade or business.[48]

Before 1950 the prevailing view was that an organization conducting a business could qualify for exemption if it dedicated its business profits to charitable ends. This "destination of income" test for exemption was applied by the Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*.[49] The Revenue Act of 1950[50] responded to the *Trinidad* decision in two ways. First, it eliminated the "destination of income" test and withdrew the exempt status of feeder corporations. An organization primarily engaged in a trade or business for profit may not qualify for exemption merely because its profits are destined for charitable ends.[51] Second, it imposed a tax on unrelated business income of most, but not all, exempt organizations:[52] "The primary objec-

45. IRS attention is evidenced by the scope of IRS Publication 598 (Rev. Nov. 87), *Tax on Unrelated Business Income of Exempt Organizations*.

46. Treas. Reg. § 1.501(c)(3)-(1)(e)(1) (as amended in 1976).

47. *Id.* § 1.501(c)(3)-(1)(c)(1).

48. *See* Gen. Couns. Mem. 39,108 (May 23, 1982).

49. 263 U.S. 578 (1924). *See* C.F. Mueller Co. v. Commissioner, 14 T.C. 922 (1950), *rev'd*, 190 F.2d 120 (3d Cir. 1951).

50. Pub. L. No. 81-814, 64 Stat. 906 (1952).

51. *See* I.R.C. § 502 (1982); *see also supra* note 3 and accompanying text.

52. *See* I.R.C. § 511(a) (1982).

tive 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 non-exempt business endeavors with which they compete."[53]

The Tax Reform Act of 1969[54] expanded the tax on unrelated business income to virtually all exempt organizations, including churches, but excluded section 501(c)(1) federal instrumentalities.[55] The 1969 Act also expanded the tax to reach some sophisticated arrangements designed to circumvent the 1950 revisions.[56]

"Unrelated business taxable income," the base upon which the tax is computed, is defined as "the gross income derived by an organization from an unrelated trade or business . . . regularly carried on . . . less the deductions allowed by . . . chapter [1] which are directly connected with the carrying on of such trade or business."[57] Expenses attributable solely to an unrelated business are allowed in full, and expenses attributable to the dual use of facilities or personnel must be allocated between exempt and unrelated business functions on a "reasonable basis."[58] After gross income has been reduced by allocable deductions, the modifications in section 512(b) and (c), which, in effect, are exclusions from the tax base, must be applied. Finally, modifications involved in the computation of unrelated business taxable income must be applied. These modifications include net operating losses, charitable contributions, and a "standard deduction" of $1,000.[59]

An organization with gross income of $1,000 or more from unrelated trade or business must file IRS Form 990-T, *Exempt Organization Business Tax Return*, and pay any tax due.[60] The

53. Treas. Reg. § 1.513-(1)(b) (as amended in 1983).

54. Pub. L. No. 91-172, 83 Stat. 487 (1970).

55. *See* I.R.C. § 511 (1982). This includes taxation of unrelated business income of exempt charitable trusts, state colleges and universities, and any corporation wholly owned by one or more such colleges or universities.

56. *See id.* § 512(b)(13) (governing use of sophisticated interest, rent, annuity, and royalty schemes by "controlled organizations"); *id.* § 514 (governing debt-financed acquisitions of property).

57. *Id.* § 512(a)(1).

58. *See* Treas. Reg. § 1.512(a)-(1)(b), (c) (as amended in 1984).

59. *See* Treas. Reg. § 1.512(b)-(1)(e), (g)(2), (h)(2) (as amended in 1981).

60. *See* Treas. Reg. § 1.6012-2(e) (as amended in 1982). If the university qualifies

tax is imposed at the regular corporate rate, currently ranging from 15-34%[61] or the regular trust rate, currently ranging from 15-28%.[62] Under the Tax Reform Act of 1986[63] exempt organizations must pay quarterly estimated taxes by making deposits through the Federal Tax Deposit System.[64]

With the foregoing in mind, the following is a summary of the computation of the unrelated business taxable income of an exempt organization. Section 511 applies the section 11 corporate tax on the section 512 unrelated business taxable income of the exempt parent. The tax is determined by a five-step process. First, the activity is scrutinized to determine whether it is an unrelated trade or business under section 513, that is, whether the activity is a "trade or business," is "regularly carried on," and is not "substantially related" to the organization's exempt functions. Second, if all three section 513 criteria are satisfied, then a determination as to the applicability of the many "exceptions" (really exemptions) under section 513 is made. Third, section 512(b) "modifications," really exclusions, are applied. Fourth, after considering all of the exceptions and modifications, if an unrelated trade or business activity captured by sections 511, 512, and 513 remains, then costs and expenses of that activity must be properly allocated or applied against income in order to fix the unrelated business taxable income.[65] Finally, if unrelated trade or business income exceeds $1,000, the organization must file IRS Form 990-T and pay the tax at the corporate rate.[66]

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as a political subdivision of the state in accordance with § 115, it does not have to file IRS Form 990, the Annual Information Return. It is still required, however, to file IRS Form 990-T. *See* Treas. Reg. § 1.6033-2(g)(v) (as amended in 1985).

61. *See* I.R.C. § 511(a)(1) (1982).

62. *See id.* § 511(b)(1).

63. Pub. L. No. 99-514, 100 Stat. 2085.

64. *See* Treas. Reg. §§ 1.6302-1 (as amended in 1987); 1.6302-2 (as amended in 1984).

65. In view of all the exceptions and exclusions, one begins to understand why Congress, the Treasury, the IRS, and the small business community are questioning how effective the unrelated business income provisions really are.

66. *See infra* APPENDIX, at Discussion Option V, which would increase the present $1,000 deduction to $5,000 or $10,000. Presently the Subcommittee is leaning toward the $10,000 amount rather than the $5,000 amount.

B. Nature of an Unrelated Trade or Business

Three elements must be present before an activity will be considered an "unrelated trade or business": (1) the activity must be a "trade or business"; (2) it must be "regularly carried on"; and (3) it must not be "substantially related" to the organization's exempt purpose, other than to the need for funds produced by the activity.[67] Even if an activity is considered to be an "unrelated trade or business," it avoids taxation if it comes within explicit statutory "exceptions" under section 513[68] or statutory "modifications" under section 512(b).[69] Each of the three elements of an unrelated trade or business will be discussed separately below.

1. "Trade or Business"

The regulations define "trade or business" by analogy to section 162, which allows a deduction for the ordinary and necessary expenses of a trade or business. The regulations suggest that if the activity is not comparable to a commercial enterprise that might be conducted by an ordinary taxpayer, the threat of unfair competition is insufficient to warrant imposition of the unrelated business tax. In an apparent attempt to distinguish "trade or business" activities from passive investment activities, the regulations also state that a "trade or business" includes "any activity carried on for the production of income from the sale of goods or performance of services."[70]

An activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities that may or may not be related to the organization's exempt purpose.[71] Thus, a profit-seeking activity can be carved out of a larger exempt endeavor and subjected to the tax.[72] Unsolicited distribution of low-cost articles incidental to

67. *See* Treas. Reg. § 1.513-1(a) (as amended in 1983).

68. I.R.C. § 513(a)(1)-(3), (d)-(h) (1982 & Supp. IV 1986).

69. I.R.C. § 512(b)(1)-(15) (1982).

70. Treas. Reg. § 1.513-1(b) (as amended in 1983).

71. *See id.*

72. For example, although publication of a journal by a bar association would be an exempt activity, the sale of advertising in the journal may be an unrelated trade or business. Similarly, an association's insurance activities may be separated or fragmented

the solicitation of charitable contributions are excepted from the term "unrelated trade or business." The aggregate value of such items may not exceed five dollars per person per calendar year.[73]

2. *"Regularly Carried On"*

The regulations look to the frequency and continuity of the activity and the manner in which it is pursued to determine whether it is "regularly carried on." If it is generally similar to comparable commercial activities of nonexempt organizations, the activity will be deemed to be "regularly carried on."[74] The regulations apply the foregoing principles and identify activities that are "regular" (those that are "seasonal" or "year round") and "not regular" (those that are "short term," "intermittent," "sporadic," or "infrequent").[75]

3. *"Substantially Related"*

The regulations offer little more than abstract generalizations in determining whether a trade or business regularly carried on is "substantially related" to the purposes for which exemption has been granted the organization. The regulations require a comparison between the business activity that generates the income in question and the organization's exempt purposes. To be related to an exempt purpose, a substantial causal relationship must exist. In other words, the activity must "contribute importantly" to the accomplishment of an exempt pur-

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from the exempt activities. *See* United States v. American Bar Endowment, 477 U.S. 105 (1986); United States v. American College of Physicians, 475 U.S. 834 (1986). *See infra* APPENDIX, at Discussion Option I.J., in connection with application of UBIT to advertising income.

73. *See* I.R.C. § 513(h); Treas. Reg. § 1.513-1(b) (as amended in 1983); *cf.* Veterans of Foreign Wars v. Commissioner, 89 T.C. 7 (1987) (Christmas card sales generated unrelated business taxable income).

74. Treas. Reg. § 1.513-1(c)(1) (as amended in 1983). *See infra* APPENDIX, at Discussion Option III, which would have repealed the "regularly carried on" test, thereby tightening up the UBIT rules. The Subcommittee, however, considered and deleted Option III on May 24, 1988. Thus, the "regularly carried on" test is still in place.

75. *See* Treas. Reg. § 1.513-1(c)(2) (as amended in 1983). The Tax Court recently rejected the National Collegiate Athletic Association's (NCAA) argument that advertisements included in publication and sale of "Final Four" programs were an "intermittent" activity and not "regularly carried on." *See* National Collegiate Athletic Ass'n v. Commissioner, 92 T.C. 27 (Feb. 28, 1989).

pose.[76] Particular emphasis is placed upon the size and extent of the activity in determining whether it contributes importantly, and if a business is conducted on a larger scale than necessary to carry out an exempt purpose, more likely it will be treated as unrelated.[77]

When applying these principles, adherence to several corollary rules is important. These corollary rules include the following: (1) income from the performance of exempt functions is not taxable;[78] (2) disposition of the product of an exempt organization is not taxable if the product is sold in substantially the same form that it was on completion of the exempt function;[79] (3) the income-producing activities that contribute importantly to the accomplishment of exempt purposes are not taxable;[80] and (4) an organization's exempt activities may create certain intangibles that may be commercially "exploited."[81]

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76. *See* Treas. Reg. § 1.513-1(d)(1)-(3); *see also infra* APPENDIX, at Discussion Option I (in connection with the recent discussions as to the "substantially related" test). The Subcommittee rejected the idea of replacing the "substantially related" test with a "directly related" test.

77. *See* Treas. Reg. § 1.513-1(d)(1)-(3) (as amended in 1983).

78. *See id.* § 1.513-1(d)(4)(i).

79. On the other hand, if a product resulting from an exempt function is used or exploited beyond what is necessary for the organization's exempt purposes, then the activity may become an unrelated business. For example, if a university has an experimental dairy herd, income from the sale of milk and cream is distinguished from income from the sale of milk and cream derivatives such as ice cream and pastries. *See id.* § 1.513-1(d)(4)(ii).

80. *See id.* § 1.513-1(d)(4)(iii). Colleges and universities frequently allow some of their exempt function facilities to be used by outsiders for commercial purposes. For example, income from a college skating rink operated for students, but rented to the public, is proportionally taxable. *See* Rensselaer Polytechnic Inst. v. Commissioner, 732 F.2d 1058 (2d Cir. 1984). In *Rensselaer* the Second Circuit affirmed the Tax Court decision permitting a university to allocate costs of a university field house, used for exempt and nonexempt purposes, based on actual hours the facility was used for each activity rather than total time the facility was available for use. The IRS is looking for finality in the allocation area, and legislation is expected. *See infra* APPENDIX, at Discussion Option VIII.

"Dual use" of university facilities has been deemed "related" or "unrelated" trade or business depending on how the arrangement is structured. For example, a tax-exempt university that leases its facilities to a professional football team for several months may or may not be engaged in an unrelated business depending on whether the university provides services, such as food or maid service, to the team. *See* Rev. Rul. 80-298, 1980-2 C.B. 197; *cf.* Priv. Ltr. Rul. 80-24-001.

81. *See* Treas. Reg. § 1.513-1(d)(4)(iv) (as amended in 1983); *see also* Priv. Ltr. Rul. 88-24-018 (March 14, 1988). For example, the sale or advertising by an exempt university's campus newspaper, although rendered with a commercial character, contributes

C. *Statutory Exceptions*

Even if an activity meets the statutory definition of unrelated trade or business, it avoids taxation if it comes within specific statutory exceptions described in section 513(a)(1)-(3) or section 513(d)-(h). One exception is a trade or business carried out by a section 501(c)(3) organization for a college or university "primarily for the convenience of its members, students, patients, officers or employees."[82] This exception has been applied, in one instance, to a laundry operated by a college for the purpose of laundering dormitory linens and the students' clothing.[83] Other examples of activities that come within the "convenience exception" are (1) operation of campus dining facilities to the extent they are used by faculty, staff and students[84] and (2) rental of dormitory rooms and similar accomodations for students.[85]

There are examples of programs, events, and activities conducted by colleges and universities that do not fall within the statutory exceptions. For example, the Alumni Association of the University of North Carolina at Greensboro, Inc. initially filed, then later dismissed, its suit against the United States[86] challenging a ruling that a travel tour program it conducted was an unrelated trade or business. The IRS generally determined that the activities of the alumni association in working with commercial travel agencies constituted a trade or business that was regularly carried on. The Service concluded that the activity was inherently recreational, did not contribute importantly to an exempt purpose, and constituted a commercial endeavor that exploited the association's membership.[87]

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importantly to the university's educational program through training of the students involved. *See* Treas. Reg. § 1.513-1(d)(4)(iv) example 5. *Compare* Rev. Rul. 72-431 examples 6, 7, 1972-2 C.B. 281 (sales of various types of advertising in exempt organization's journal).

82. I.R.C. § 513(a)(2) (1982).

83. *See* Treas. Reg. § 1.513-1(e)(3) (as amended in 1983).

84. *See* Rev. Rul. 58-194, 1958-1 C.B. 240.

85. *See id.* 76-33, 1976-1 C.B. 169.

86. *See* Alumni Ass'n of the Univ. of N.C. v. United States, 223 Ct. Cl. 765 (1980).

87. *See* Rev. Rul. 78-43, 1978-1 C.B. 164. For a discussion of alumni association travel and tour programs offered in conjunction with courses of study, see Rev. Rul. 70-534, 1970-2 C.B. 113; Priv. Ltr. Rul. 81-15-025 (Jan. 2, 1981). For evidence of the IRS's increasingly hard-nosed attitude toward vacations disguised as continuing education for

After initially determining that Texas Christian University, Michigan State University, the University of Southern California, the University of Kansas, and the Cotton Bowl Athletic Association derived unrelated trade or business income from television and radio broadcasts of athletic events, the IRS reversed its position and concluded that although the activities constituted a regularly carried on trade or business, the activity was related to the universities' and the association's tax-exempt educational functions. Later, the IRS issued a favorable ruling regarding the sale of broadcasting rights to a national radio and television network in connection with an annual athletic event held by an organization created by a regional collegiate athletic conference composed of tax-exempt universities.[88]

Although Treasury Regulation section 1.513-1(e)(2) generally excepts sales by university book stores, the IRS will isolate sales that are not sold primarily for the convenience of students and university employees.[89] Thus, all sales, other than items that would be unrelated but for the convenience doctrine, would be taxed.[90]

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professionals, see Tech. Adv. Mem. 88-32-003 (August 12, 1988), and *IRS to Crack Down on Charitable Solicitation*, 42 TAX NOTES 1039 (1989). *See infra* APPENDIX, at Discussion Option I.D.

88. *See* Rev. Rul. 80-296, 1980-2 C.B. 195.

89. *See* Priv. Ltr. Rul. 80-04-010 (university-sponsored bookstore's sale of watches subject to UBIT).

Although not a UBIT issue, a "university athletics" topic that has received considerable attention recently is the question of the extent of § 170 deduction for amounts paid to qualified institutions of higher education described in § 170(b)(1)(A)(ii), for the preferential right to purchase tickets to athletic events in the institution's athletic stadium. Section 6001 of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (1988) (TAMRA), adds new I.R.C. § 170(m) providing that 80% of the amount paid to a qualified institution shall be allowable as a deduction. If any portion of such payment to the educational institution is for the actual purchase of tickets, the portion allocable to the ticket purchase is not deductible, and the 80% rule applies to the remaining amount of the taxpayer's payment to the institution after subtraction of the ticket cost. The legislation is effective for taxable years beginning after December 31, 1983, except that refunds or credits attributable to § 170(m) will be permitted if claims are filed within one year of the date of enactment of TAMRA, even if such refunds or credits are otherwise barred.

90. Priv. Ltr. Rul. 80-25-222 (sales of various items by campus stores). *See infra* APPENDIX, at Discussion Options I.A. and II.

D. *Statutory Modifications*

After an unrelated trade or business has been identified, the next step is to ascertain unrelated business taxable income. Section 512(a)(1) defines unrelated business taxable income as the gross income derived from the unrelated business less directly connected deduction items. Both are computed with certain modifications contained in section 512(b). Most of these "modifications" are really exclusions and, coupled with statutory and other exceptions, represent significant inroads into the concept of unrelated trade or business.

1. *Passive Investment Income Modifications*

Several modifications to the unrelated business tax will exempt various types of passive investment income. Dividends,[91] interest,[92] annuities,[93] royalties,[94] certain rents,[95] and capital gains[96] are all exempted from the unrelated business tax. These exclusions, however, may not apply in the case of certain "debt financed" property.[97]

The royalty exclusion includes overriding royalties and royalty income received from licensees by an exempt organization that legally and beneficially owns patents assigned to it by inventors for a specified percentage of future royalties.[98] The exclusion does not apply to mineral royalties connected with cer-

91. *See* I.R.C. § 512(b)(1) (1982).
92. *See id.*
93. *See id.*
94. *See id.*; Treas. Reg. § 1.512(b)-1(b) (as amended in 1981).
95. *See* I.R.C. § 512(b)(3)(A)(i) (1982).
96. *See id.* § 512(b)(5).
97. *See id.* § 512(b)(4).
98. A royalty is a payment for the use of a variable right such as a trademark, tradename, or copyright, but royalties do not include payments for personal services. *See* Rev. Rul. 76-297, 1976-2 C.B. 178. When the organization holds bare legal title to the inventions only for the purpose of performing the agreed patent development and management on behalf of universities and their researchers, the amounts paid do not retain their character as royalties and, therefore, are not excludable. *See* Rev. Rul. 73-193, 1973-1 C.B. 262. Significant developments, however, are underway in the area of royalties, including efforts to ensure that only pure passive royalty income from property, created by a third party and contributed to the exempt organization, would escape UBIT. *See infra* notes 160, 161 and accompanying text (addressing Discussion Option IV, which would severely limit or restrict the present royalty exemption).

tain "working interest" agreements.[99]

In a related area, the IRS recently has begun to raise questions about the application of the unrelated business taxable income rules to "affinity card" programs. In these programs, an exempt organization licenses the use of its membership lists to a third party who, in turn, markets credit cards to its members. The IRS initially decided that although the licensing of mailing lists for the purpose of marketing credit cards was an exploitation of the organization's exempt function, receipts were not taxable because they constituted royalty income.[100] This ruling, however, has been revoked recently.[101]

Generally speaking, rents from real property are excludable as passive investment income.[102] Rents from personal property are excludable only if there is a mixed lease and the rents attributable to the personal property are an "incidental" part, not more than ten percent, of the total rents received from the lease.[103] In a mixed lease, if the amount attributable to personal property is more than incidental but not more than fifty percent of the total, the real property rent is excludable but the personal property rent is not. If, however, the personal property rent is more than fifty percent of the total, then none of the rent is excludable.[104]

Because rental of real estate can constitute the carrying on of a "trade or business," care must be taken to assure that income from the activity will constitute excludable rent.[105] Also, if a payment termed "rent" by the parties is, in fact, a return of profits for a person operating the property for the benefit of a tax-exempt organization or a share of the profits retained by

99. *See* Treas. Reg. § 1.512(b)-1(b) (as amended in 1981).

100. *See* Priv. Ltr. Rul. 87-47-066 (Aug. 28, 1987).

101. *See* Gen. Couns. Mem. 39,727 (Jan. 25, 1988) (discussing the legal rationale for subjecting exempt organizations to UBIT in connection with the sale of affinity card or mailing lists); *see also* Priv. Ltr. Rul. 88-23-109 (March 17, 1988) (distinguishing mailing list exchanges between exempt organizations). Affinity card programs have been the target of much discussion by the House Subcommittee on Oversight. *See infra* APPENDIX, at Discussion Option I.I.

102. *See* I.R.C. § 512(b)(3)(A)(i) (1982).

103. *See id.* § 512(b)(1)(A)(ii); *see also* Treas. Reg. § 1.512(b)-1(c)(2)(ii) (as amended in 1981).

104. I.R.C. § 512(b)(3)(B)(i) (1982).

105. *See* Treas. Reg. § 1.512(b)-1(c)(5) (as amended in 1981) (payments for services rendered primarily for the convenience of occupants will not be considered as being a passive source but instead as being from an unrelated trade or business).

such organization as a partner or joint venturer, such payment is not within the rent exclusion.[106]

Gains and losses from the disposition of property also are excludable as a passive investment income modification. The disposition of inventory or property held primarily for sale to customers in the ordinary course of a trade or business, however, is not excludable.[107] Furthermore, the exclusion does not apply to the cutting of timber that constitutes a sale or exchange of such timber.[108] The exclusion, as noted below, does not apply to property that is debt-financed. Otherwise, the exclusion applies to virtually all capital gains.[109]

2. *Debt-Financed Property*

If an exempt organization borrows funds to acquire income-producing property, all or part of the income — that is, the amount ascertained under section 514(a)(1) — may be included in the unrelated business taxable income, even if it otherwise would have been excluded under section 512 (b)(1), (2), (3) or (5).[110]

Before 1969, exempt organizations were in a unique position to leverage their tax exemptions by engaging in certain "bootstrap operations"; they acquired businesses and other property on credit and then operated them, frequently through net leasing arrangements with sellers. Under these arrangements the sellers paid all expenses on the property and remitted a net rental to the exempt organization. The tax-free rent received by the organization enabled it to amortize the mortgage and still realize a profit. In 1969 Congress extended section 514 to include as "unrelated business taxable income" any passive income of any exempt organization to the extent that the property generating that income was acquired, directly or indirectly, with borrowed funds. Even securities purchased on margin may constitute debt-financed property,[111] but the wide reach of section 514

106. *See id.* § 1.512(b)-1.

107. *See* I.R.C. § 512(b)(5) (1982).

108. *See* I.R.C. § 631(a) (Supp. IV 1986).

109. *See* Treas. Reg. § 1.512(b)-1(d)(1) (as amended in 1981).

110. I.R.C. § 512(b)(4) (1982).

111. *See* Elliott Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347 (3d Cir. 1980).

is compromised by numerous exceptions.[112]

This article is not intended to address the intricacies of section 514; however, two phrases and their application so pervade the statute that a general discussion of each is warranted. The first pervasive phrase is "unrelated debt-financed income." An exempt organization must include in unrelated business taxable income a certain percentage of gross income from debt-financed property less a similar percentage of allocable deductions.[113] Income items potentially covered are rent, interest, dividends, capital gains and the like, typically passive investment income described in section 512(b)(1), (2), (3) and (5). Section 514 does not apply to amounts that otherwise are included in the computation of unrelated business taxable income, such as rents from personal property includable under section 512(b)(3) or rents and interests from controlled organizations includable under section 512(b)(13).[114]

The second pervasive phrase is "debt-financed property." Debt-financed property is defined as that property, held to produce income (for example, rental real estate, tangible personal property, and corporate stock) and with respect to which there is "acquisition indebtedness" at any time during the taxable year.[115] This definition, however, has several exceptions. If "substantially all," 85% or more, of the property's use is "substantially related" to the exercise or performance of the organization's exempt purposes, then no part of the property is treated as debt-financed.[116] Thus, where a college or university owns an office building subject to a large mortgage and at least eighty-five percent of the building is used for college or university activities, the fact that fifteen percent may be rented to outsiders may not cause the property to be treated as debt-financed.

If the property is used both for exempt activities and for the

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112. For a discussion of alternative methods for reducing or minimizing unrelated business taxable income to tax-exempt partners investing in real estate with prospective debt-financed improvements, see Kanter & Banoff, *Tax-Exempt Partners and Debt-Financed Improvements*, 70 J. TAX'N 388 (1989). *See also* Pvt. Ltr. Rul. 89-21-103 (May 26, 1989) (educational institution's support organization may participate in construction and lease of building without accruing UBIT, and lease does not constitute debt-financed property for purposes of I.R.C. § 514(b)).

113. *See* Treas. Reg. § 1.514(a)-1(a).

114. *See* Treas. Reg. § 1.514(b)-1(b)(2)(ii) (as amended in 1980).

115. *See* I.R.C. § 514(b)(1) (1982); Treas. Reg. § 1.514(b)-1(a).

116. *See* I.R.C. § 514(b)(1)(A)(i); Treas. Reg. § 1.514(b)-1(b)(l)(i).

production of income, but less than eighty-five percent of the use of the property is devoted to the organization's exempt purpose, the property will be considered debt-financed only in proportion to the nonexempt use.[117] Thus, when a college or university owns a four-story office building subject to a large mortgage and two floors are used for college or university administration and the other two floors are rented to the public, only the rented portion of the building is treated as debt-financed.[118]

3. *Research Income*

Income from certain research grants or contracts may be excluded from unrelated business taxable income depending upon the nature of the research performed. Excluded is income from research performed for any level of government[119] research performed by a college, university or hospital "for any person,"[120] and "fundamental" (as distinguished from "applied") research performed "for any person" when the results are freely available to the general public.[121] The regulations limit these exclusions by defining research as activities other than those "of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."[122] The regulations also stipulate that "[t]he term 'fundamental research' does not include research carried on for the primary purpose of commercial or industrial application."[123]

117. *See* I.R.C. § 514(b)(1)(A)(ii); Treas. Reg. § 1.514(b)-1(b)(l)(ii).

118. *See* Treas. Reg. § 1.514(b)-1(b)(1)(iii) example 2 (as amended in 1982). Additional exceptions to the definition of "debt-financed property" include: income subject to unrelated business taxable income under the general rules of §§ 511-513; property used in research if the income is excludable from unrelated business taxable income under § 512(b)(7), (8) or (9); property used in certain volunteer, convenience, or thrift business described in § 513(a)(1)-(3); income-producing real estate acquired for future use for exempt purposes; and income from debt-financed property of a partnership that includes taxable and exempt organizations, if each allocation to a tax exempt partner is a qualified allocation under the tax-exempt leasing rules or if the partnership meets the rules of new § 514(c)(9)(E).

119. *See* I.R.C. § 512(b)(7) (1982).

120. *Id.* § 512(b)(8).

121. *Id.* § 512(b)(9).

122. Treas. Reg. § 1.512(b)-1(f)(4) (as amended in 1981).

123. *Id.*

Two cases have a significant impact upon colleges and universities, as well as on the treasury regulation noted above. In *Mid-West Research Institute v. United States*[124] about seventy-five percent of a section 501(c)(3) organization's work was for the government, and the balance was for the industry sponsors. In *IIT Research Institute v. United States*[125] a separately incorporated section 501(c)(3) entity created by the trustees of the predecessor of the Illinois Institute of Technology undertook both contract research for industry and government, as well as "in-house" projects suggested by its own scientific investigators. The IRS never challenged the basic section 501(c) exemption in either case. Instead, the Service challenged, as being "unrelated," virtually all the nongovernmental work on three grounds. It contended that: (1) all results had to be published;[126] (2) the research constituted unfair competition with tax-paying businesses; and (3) some of the projects undertaken were not "scientific" but, instead, were "testing."

The *Mid-West Research* court rejected the government's contention that all nongovernmental research results had to be published in order to qualify as scientific research in the public interest. The court also held that scientific research performed for private sponsors for the purpose of aiding industrial development in a geographic area is a tax-exempt activity and rejected the argument that unfair competition with tax-paying businesses was, in itself, determinative of taxable status. In the *IIT Research* case the Court of Claims concluded that all the institute's projects undertaken for industry met the test of scientific research because they were carried on by professionals and because the institute did not involve itself with the "commercialization" of the products or processes that it developed. The court also rejected the Service's argument that all scientific research must be published and concluded that the research contracts were related to the institute's exempt purposes.[127]

124. 554 F. Supp. 1379 (W.D. Mo. 1983), *aff'd*, 744 F.2d 635 (8th Cir. 1984).

125. 9 Ct. Cl. 13 (1985).

126. *See* Rev. Rul. 76-296, 1976-2 C.B. 141.

127. *See* Kertz & Hasson, *University Research & Development Activities: The Federal Income Tax Consequences of Research Contracts, Research Subsidiaries and Joint Ventures*, 13 J. COLL. U.L. 109 (1986).

4. *Passive Income (Except Dividends) From Controlled Organizations*

Section 512(b)(13) governs taxation of passive income — interest, annuities, rents, and royalties — which exempt parent organizations receive from taxable subsidiaries that they control within the meaning of section 368(c). Exempt parent organizations, however, are not taxed on passive income from subsidiaries they do not control.[128] Not only is the receipt of passive income from a noncontrolled organization nontaxable, but the formation of a wholly owned taxable subsidiary to engage in for-profit activities is permissible without any effect on the exempt status of the parent. Also, the formation of a wholly owned, taxable subsidiary is permissible without any taxable income of the subsidiary being imputed to the unrelated business income of the parent and without any unrelated business income being realized by the parent on the transfer from the parent to the subsidiary.[129] Excessive involvement by the exempt parent in the day-to-day management and operations of the subsidiary, however, will cause the IRS to ignore the separate status of the corporations and attribute subsidiary income to the parent.[130]

Without section 512(b)(13), an exempt organization might be tempted to establish a for-profit, wholly owned subsidiary for the purpose of operating a trade or business unrelated to the organization's exempt purposes. It then might convert otherwise taxable business income into passive investment income through the payment of interest, rent, royalties, or other items that would be deductible to the subsidiary and excluded from the unrelated business taxable income of the exempt parent. Section 512 (b)(13) precludes this avoidance technique by effectively

128. I.R.C. § 512(b)(1), (2), (3), (5) (1982). *See infra* APPENDIX, at Discussion Option VII (discussing proposed changes in the definition and application of "control").

129. *See* Priv. Ltr. Rul. 87-06-012 (Oct. 31, 1986); Priv. Ltr. Rul. 85-10-937 (Feb. 12, 1985); Gen. Couns. Mem. 39,598 (Dec. 8, 1986); Gen Couns. Mem. 39,326 (Aug. 31, 1984).

130. *See* Priv. Ltr. Rul. 87-16-054 (Jan. 20, 1987) (when parent so controls affairs of subsidiary such that subsidiary is mere instrumentality of parent, subsidiary's corporate entity may be disregarded); Priv. Ltr. Rul. 87-06-012 (Oct. 31, 1986) (same). *Compare* Priv. Ltr. Rul. 87-47-033 (Aug. 25, 1987) (lack of interlocking directorates a favorable factor) *and* Priv. Ltr. Rul. 87-18-066 (Feb. 5, 1987) (same) *and* Priv. Ltr. Rul. 87-06-012 (Oct. 31, 1986) (overlapping directorates not necessarily fatal) *with* Priv. Ltr. Rul. 86-06-056 (Nov. 14, 1985) (overlapping directorates constitute day-to-day management of subsidiary by parent).

tracing the passive income back to the subsidiary's business operations and treating it as unrelated business taxable income to the exempt parent to the extent that it was not taxed to the subsidiary. This is achieved by including passive income received from controlled organizations in the exempt parent's unrelated business taxable income at a specific ratio that varies depending on whether the controlled organization is exempt or nonexempt.[131]

If the subsidiary is tax-exempt, the passive income items are includable in the business taxable income of the exempt parent in accordance with the following formula:[132]

$$\text{Income Item} \times \frac{\text{UBIT of Subsidiary}}{\text{Greater of Subsidiary's ``Taxable Income'' or Subsidiary's ``UBIT''}}$$

For this purpose, the taxable income of the subsidiary is determined as if it were not exempt from tax, but in all events it may not be less than the subsidiary's unrelated business taxable income. Both amounts must be computed without regard to the amounts paid directly or indirectly to the exempt parent.

If the subsidiary is not tax-exempt, the passive income items are includable in the unrelated business taxable income of the exempt parent in accordance with the following formula:[133]

$$\text{Income Item} \times \frac{\text{Subsidiary's ``Excess Taxable Income''}}{\text{Greater of Subsidiary's ``Taxable Income'' or ``Excess Taxable Income''}}$$

For this purpose, excess taxable income is the subsidiary's total taxable income less the taxable income that, if derived directly by the exempt parent, would not be unrelated business taxable income. Thus, if income in the form of interest, rent, annuities, or royalties is received from a controlled, nonexempt organization, not all of that income necessarily is unrelated income to the parent tax-exempt organization if, in the same year, the sub-

131. *See* Treas. Reg. § 1.512(b)-1(l) (as amended in 1981).
132. *See id.* § 1.512(b)-1(l)(2).
133. *Id.* § 1.512(b)-1(l)(3).

sidiary receives income that would be related income if received by the tax-exempt parent.[134]

5. Partnerships

An organization generally may qualify for exemption under section 501(c) if it is a general partner in a limited partnership. The partnership arrangement, however, must permit the organization to act to further its exempt purposes, and the organization must insulate itself against any statutory obligation to maximize limited partners' profits.[135] The general rule is that an exempt organization must include its share, whether or not distributed, of the gross income of a partnership of which it is a member if the trade or business regularly carried on by the partnership is an unrelated trade or business.[136] Section 5074 of The Technical and Miscellaneous Revenue Act of 1988[137] adds a new requirement to section 6031 of the Internal Revenue Code concerning the information-reporting obligations of partnerships. Partnerships engaging in a trade or business will be required to supply their tax-exempt partners with the information necessary to enable them to compute their distributive shares of partnership income that is subject to the unrelated business income tax. The amendment is applicable to taxable years beginning after December 31, 1988. The following cases illustrate actions taken by the IRS concerning partnerships.

Cases resulting in an application favorable to the exempt organization include those in which:

(1) federally imposed restrictions in the structure of the partnership agreement protect the exempt organization from potential conflict between its exempt purposes and its obligations as a general partner under partnership law;[138]

(2) a controlled group's members serve as limited partners

134. B. Hopkins, *supra* note 18, at 772.

135. *See* Cerny, *Current Developments in the Unrelated Business Area - IRS Perspective*, 1988 Representing and Managing Tax-exempt Organizations 227,260 (Georgetown University Law Center); McGovern, *Tax-Exempt Organizations as Partners and Joint Venturers as Viewed by the Service*, 15 N.Y.U. Conf. Char. Orgs. 3-1 (1987); Sanders, *Exempt Organizations as Participants in Limited Partnerships and Joint Ventures*, 15 N.Y.U. Conf. Char. Orgs. 2-1 (1987).

136. *See* I.R.C. § 512(c)(1) (1982).

137. Pub. L. No. 100-647, 102 Stat. 3342 (1988).

138. *See* Gen. Couns. Mem. 39,005 (Dec. 17, 1982).

with an independent committee monitoring activities;[139] and

(3) liability is limited through insurance, indemnity agreements, or the nature of the partner's activities, *and* the limited partnership meets the partnership criteria set forth in Revenue Procedure 72-13[140] and Revenue Procedure 74-17.[141]

Cases resulting in an application unfavorable to the exempt organization include those in which:

(1) an exempt hospital's subsidiary is: (a) a general partner in a limited partnership that leases, subleases, and manages a medical office building; (b) the partnership is controlled by hospital staff physicians who sublease most of the building's space to another partnership that they control; (c) the partnership confers substantial private benefit on the physicians; and (d) the benefit is not merely incidental to accomplishing exempt purposes;[142] and

(2) profits are received by an exempt organization that is a limited partner even though the partnership involvement does not jeopardize exempt status.[143]

IV. CURRENT DEVELOPMENTS

1. *Overview*

During 1987 and 1988 a myriad of factors and events resulted in widespread and intense review of the tax-exempt sector, particularly the trade or business activities of exempt organizations. This review was prompted by complaints regarding misuse by some television ministries[144] of this exemption for churches[145] and by lobbying and political activities, as well as

139. *See* Gen. Couns. Mem. 39, 444 (July 18, 1985).

140. Rev. Proc. 72-13, 1972-1 C.B. 735.

141. Rev. Proc. 74-17, 1974-1 C.B. 438.

142. *See* Gen. Couns. Mem. 39,598 (January 23, 1987), *clarified in* Gen. Couns. Mem. 39,646 (June 30, 1987). *Compare* Priv. Ltr. Rul. 88-20-093 (May 20, 1988) (no UBIT as to amounts received by hospital and its tax-exempt affiliate/general partner from partnership with physicians as limited partners) *with* Gen. Couns. Mem. 39,732 (Nov. 4, 1987) (exempt status of § 501(c)(3) hospital is not jeopardized when hospital serves as general partner in a physical therapy limited partnership with nonexempt entities and physicians serving as limited partners).

143. *See* Service Bolt & Nut Co. Profit-Sharing Trust v. Commissioner, 78 T.C. 812 (1982), *aff'd*, 724 F.2d 519 (6th Cir. 1983).

144. *See infra* APPENDIX, at Discussion Option I.K.

145. Focusing on the commercial nature of church members' payments to the

commercial and competitive practices of public charities. Three other concerns also prompted the review: (1) concern over the literal explosion in reorganizations, joint ventures,[146] and affiliated activities of hospital systems; (2) concern over the distinction between commercial testing and exempt function research; and (3) concern over the sale of certain items by college or university book stores and museum gift shops. In addition, considerable concern has arisen because of media coverage emphasizing misapplication of fundamental concepts underpinning tax exemption — the collapse of the Jim Bakker/PTL empire is perhaps the most prominent example — and increasing pressure on the federal government to find additional sources of revenue to reduce the federal deficit. Finally, closer scrutiny by state and local governments and the public accountability of exempt organizations to authorities such as the state attorney general,[147] secretary of state, and legislative audit counsel has sparked new controversy in this area.

Several other factors have contributed to the general antipathy towards exempt organizations: (1) the general concern that the numerous exceptions and modifications to sections 512, 513, and 514 have eroded the UBIT concept; (2) the inability to distinguish readily between certain activities of the exempt organizations sector and the for-profit sector; (3) the inability of the statutory and regulatory authority to stay abreast of the accelerating evolution in exempt organizations activity; and (4) the difficulties that the IRS (the administrative sector) and the Department of the Treasury (the policy-making sector) have, primarily because of staff limitations, in addressing such a complicated and rapidly changing area.

These factors, coupled with pressure from voters, provided

Church of Scientology for the church's "auditing and training sessions," a sharply divided U.S. Supreme Court has just affirmed a 1984 Tax Court holding that the payments were not deductible under I.R.C. § 170, concluding that the external features of the transaction "strongly suggest a *quid pro quo* exchange" of the members' money for the church's auditing and training sessions. *See* Hernandez v. Commissioner, ___ U.S. ___ (Docket No. 87-963, filed June 5, 1989).

146. *See* Brier, *Joint Ventures Between For-Profit and Exempt Organizations*, 1 TAX-EXEMPT ORGANIZATIONS (P-H) ¶ 3068 (April 1989).

147. *See, e.g.*, Riley v. National Fed'n of the Blind, 108 S. Ct. 2667 (1988) (holding that provisions of a North Carolina statute regulating the reasonableness of fees professional fund-raisers charge to charities violate the first amendment rights of a soliciting charity or its professional fund-raising solicitor).

more than enough incentive for Congress to undertake revenue-raising proposals. In an effort to seek ways to reduce the federal deficit, the House Committee on Ways and Means generated a variety of options, including: (1) a five percent excise tax on the net investment income of all tax-exempt organizations; (2) inclusion of net investment income of trade, business, and professional associations in unrelated business taxable income; (3) repeal of the tax-exempt status of health maintenance organizations and credit unions; and (4) several proposals that would erode tax incentives for charitable giving.[148]

Other areas also have received attention. Congress has addressed questions regarding disclosure of lobbying and political activities. On March 12, 1987, the House Subcommittee on Oversight held hearings on the lobbying and political activities of tax-exempt organizations. As a result of those hearings, Congress passed several reform measures as part of the Omnibus Budget Reconciliation Act of 1987.[149] The Treasury and the IRS have issued revised proposed regulations as to permissible lobbying expenditures of public charities that elect to have their legislative efforts governed by section 501(h) of the Code.[150] Congress also passed new disclosure laws concerning solicitations by non-section 501(c)(3) organizations and public inspection of IRS Forms 990, 1023 and 1024.[151] The laws became effective on February 1, 1988. In addition, the IRS is continually updating exempt organizations with information in the general area of reporting and compliance.[152]

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148. *See generally* B. HOPKINS, *supra* note 18, at x (Supp. 1988).

149. Pub. L. No. 100-203, §§ 10711-10714, 101 Stat. 1330, 1464-72 (1987).

150. *See* Treas. Reg. §§ 56.4911-1 to -7 (proposed) (Dec. 22, 1988); *see also* Witherspoon, *IRS Eases Proposed Regulations on Lobbying by Public Charities*, 1 J. TAX'N OF EX. ORGS. 18 (1989).

151. *See* Pub. L. No. 199-203, §§ 10701-10705, 101 Stat. 1330, 1457-64 (1987).

152. *See* I.R.S. Announcement 89-6, 1989-2 I.R.B. 20 (updating I.R.S. Publication 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION (rev. ed. Oct. 1988)); *see also* Rev. Proc. 89-4, 1989-3 I.R.B. 18 (discussing user fees of between $150 and $300 for obtaining I.R.S. Exempt Organization Determination Letters); *see also* I.R.S. News Release 112-88-120 (Aug. 4, 1988), restating Rev. Rul. 67-246, 1967-2 C.B.104, and urging tax-exempt charities to inform taxpayers accurately about the deductibility of contributions made in connection with charitable fundraising events.

2. *Unrelated Business Income Taxation*

The most significant developments have grown out of recent IRS, Treasury, and Congressional deliberations over UBIT. During late June 1987, the House Subcommittee on Oversight held extensive hearings on competitive, commercial, and perceived unrelated activities of tax-exempt organizations. On March 31, 1988, Subcommittee Chairman J. J. Pickle released a document entitled "Preliminary Discussion Options"[153] and requested public comments by April 15, 1988. Following public response, the Subcommittee held closed meetings during May and June 1988 to compare various options.[154] During June 1988, the tax press published Chairman Pickle's June 23, 1988, memorandum and draft report to members of the Subcommittee.[155] By letter dated October 14, 1988, Ways and Means Chairman Dan Rostenkowski and others requested the IRS to continue its revision of Forms 990 and 990T and stated that the Subcommittee would be expected to report to the full Ways and Means Committee "early in the next Congress."[156]

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153. *See infra* APPENDIX, setting forth text of the March 31, 1988 Preliminary Discussion Options. The Discussion Options are not specific recommendations, but serve as a starting point for the Oversight Subcommittee's final deliberations. Subcommittee Chairman Pickle stated that the Subcommittee members had agreed that public comment should be received before any decisions could be made.

154. *See Side-By-Side Description of Unrelated Business Income Tax Proposals, Considered by House Ways and Means Oversight Subcommittee, May 24, 1988,* Daily Tax Rep. (BNA) No. 101, at L-7 (May 25, 1988).

155. *See Proposed Letter to House Ways and Means Committee Chairman Along With Memorandum to Ways and Means Oversight Subcommittee Members From Subcommittee Chairman . . . And Attached Draft Report,* Daily Tax Rep. (BNA) No. 122, at L-4 (June 24, 1988).

Many commentaries have been made in connection with the draft report, including remarks by: Milton Cerny (*Planning and Key Developments Under the Existing Unrelated Business Income Tax*); A. L. Spitzer (*Proposals to Change the Unrelated Business Income Tax: Tax Policy Considerations*); and Thomas A. Troyer (*Proposals to Change the Unrelated Business Income Tax: The Practitioner's View*) — all of which were presented at the Tax Exempt Charitable Organization Conference, ALI-ABA/ABA Section of Taxation Course of Study (Nov. 1988). *See also* Spitzer, *Reform of the UBIT: An Open Letter to Congress,* 43 Tax Notes 195 (April 10, 1989); Troyer, *Changing UBIT: Congress in the Workshop,* 41 TAX NOTES 1221 (December 12, 1988).

156. Letter from Rep. Dan Rostenkowski, Rep. J.J. Pickle, Rep. Bill Archer, and Rep. Richard T. Schulze to IRS Commissioner Lawrence B. Gibbs (Oct. 14, 1988), *reprinted in* 41 TAX NOTES 463 (October 24, 1988). In the letter, the Service was urged to require more specific information on IRS Forms 990 and 990T filed by exempt organizations, including information specifying the basis upon which each activity is claimed to

While Congress prepares to focus attention on nonprofit organizations in the coming months, now is the time to consider some of the many forces shaping the law of tax-exempt organizations and to recognize the likelihood of significant reformation of the law of unrelated business income taxation. In this context, it is appropriate to address some of the specific recommendations in the draft report and to recognize their strengths and weaknesses.

The Department of the Treasury has testified several times about the UBIT, and several aspects of its analysis represent a departure from the traditional justification for the UBIT, the prevention of "unfair competition." Treasury posited two new justifications for the UBIT that include notions of economic efficiency and accountability even though neither of the concepts was reflected in the original legislative history. Both justifications manifest the Treasury's desire to place restrictions on the activities of exempt organizations even if no taxable competitor is being disadvantaged.

The Treasury Department contends that the UBIT serves the goal of economic efficiency by taxing commercial-type activities that are already adequately supplied by the private sector.

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be related to the organization's exempt purposes, the income produced by such activity, and a description of any related or unrelated business activity not previously reported by the organization. Committee members also requested that the Service better coordinate its programs for examination of exempt organization information and unrelated business income tax returns and make modifications to the returns no later than the due date for returns for the 1989 tax year.

IRS Legislative Liaison responded and advised that the Service is designing a new schedule for the Annual Information Return (IRS Form 990), which is intended to provide detailed information about each revenue source. Legislative Liaison further advised that the current plan contemplates that the following information be provided by the larger organizations: the nature of the income-producing activity; the amount of gross receipts from each; whether the income was unrelated; whether the income was not exempt function income but nevertheless excluded from tax and, if so, the specific [Internal Revenue] Code provision which excluded it (identified by an exclusion code); and whether the income was derived from the performance of an exempt function of the organization. This new schedule, which exists in draft form, is intended to become effective for 1989.

In recognition of the aggregate reporting burden increase to be caused by these developments, the IRS has proposed a shortened version of the annual information return for smaller organizations. This new return will be Form 990EZ, and it will be available for organizations with less than $500,000 in assets or $100,000 in gross receipts. *See* Daily Exec. Rep. (BNA) No. 7, at L-7-12 (Jan. 11, 1989); and 42 TAX NOTES 1053 (February 27, 1989).

This argument must be questioned. In the case of for-profit colleges, one must wonder whether the quality of the education they afford is as good as that provided by traditional exempt colleges and universities. One also must question whether there would be an "adequate supply" of the proper quality of education if exempt colleges and universities were made taxable.[157]

The Treasury Department also claims that the UBIT helps ensure that tax-exempt organizations remain accountable to third-party donors. While charities ought to be held publicly accountable for their behavior, one must wonder whether the UBIT is the right device for achieving this goal. For example, in recent years, major abuse of the privilege of tax-exemption arising from lack of accountability has resulted in the diversion of funds to private benefit.[158] The most effective approach to accountability in such instances is not by taxing an organization's unrelated business income. Rather, it is to implement self-dealing sanctions such as those applied against private foundations or to use other techniques for strengthening both the substance and enforcement of the rules prohibiting private benefit.

Several recommendations contained in the draft report concerning colleges, universities, and their tax-exempt supporting foundations are particularly appropriate for review and comment. The draft report retains the present "substantially related" test for UBIT and the exceptions from UBIT for a trade or business not "regularly carried on." In view of the well-developed authority interpreting this statutory language, the Subcommittee has acted prudently. On the other hand, several recommendations are controversial, unwise, and not grounded in sound policy.[159]

One recommendation that deserves particular criticism is

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157. *See* Troyer, *supra* note 155, at 1227.

158. *See, e.g.*, Benton v. Bakker (*In re* Heritage Village Church & Missionary Fellowship, Inc.), 92 Bankr. 1000 (Bankr. D.S.C. 1988) (adversary proceeding in bankruptcy concerning mismanagement of PTL ministry by Jim Bakker).

159. Among the controversial recommendations is the requirement that charities' taxable subsidiaries pay tax at the higher of the amount computed under the normal corporate rules or the amount of UBIT that would have been paid if the subsidiary had conducted its activities in the parent charity. This will result in extensive administrative problems for the subsidiary, the parent, and the IRS. Another recommendation would necessitate implementation of complex set rules for aggregating all activities of affiliated groups of organizations, exempt and taxable, to determine whether the primary purpose of the parent is charitable.

the proposed taxation of royalties in connection with property created by colleges, universities, or their tax-exempt supporting foundations.[160] Here, the principal issue is the proper tax treatment of entirely passive arrangements under which patents, copyrights, or other intangibles are licensed to taxable organizations for development, production, promotion, or sale by the licensee. The tax-exempt licensor receives royalties or payments for use of the licensed property and continues with its exempt activities. Apparently, there has been no allegation or evidence that unfair competition underlies the recommendation to tax such royalties, and neither the Treasury nor the draft report attempts to justify the recommendation on these grounds. Current law, moreover, clearly provides the IRS with ample latitude to confine the royalty exclusion to the entirely passive situations for which it was designed and to tax arrangements by which the licensed products are used for production, marketing, and sales.[161] The extension of the UBIT to such situations would deny charities the historic means of supporting themselves from passive sources on a tax-exempt basis. It would introduce a perilously broad new policy basis for the UBIT and encroach upon the same rationale that extends tax-exempt treatment to interest and rental income.

The Discussion Options and the recommendations in the draft report portend significant changes for nonprofit organizations, particularly with respect to reformation of the law of unrelated business income taxation. How much legislation will appear over the next two years is dependent upon several factors including: (1) the success of lobbying by small business; (2) the success of lobbying by tax-exempt organizations; and (3) the introduction of a tax bill. Lobbying is expected to intensify, and a tax bill most probably will be introduced during the 101st Congress. Nevertheless, although unrelated business income tax proposals possibly could be cast as revenue-raising proposals and included in a blend of tax raises and spending cuts,[162] chances of

160. *See infra* APPENDIX, at Discussion Option IV; *see also supra* note 98 and accompanying text.

161. When the licensee exploits the use of intellectual property for commercial purposes (by developing articles for merchandising, manufacturing the merchandise, advertising, or promoting and distributing the property), the licensee is taxed as a for-profit enterprise.

162. Revenue-raising ideas include taxation of investment income, reduction of the

UBIT reform do not appear likely for 1989.[163] In any event, however, tax-exempt organizations should expect to begin immediately shouldering an ever-increasing burden of disclosure, information reporting, and compliance with IRS data collection and audit activity. In the final analysis, developments in the tax laws are expected to provide rough sledding for tax-exempt organizations during the coming months.

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scope of the charitable deduction, taxation of affinity card programs, focus on activities of exempt hospitals, and limitations in the area of charitable fund-raising. In addition, many legislators are disgruntled over tax-exempt organizations that are funded, not by gifts and grants, but by fee-for-service income and investment income. Apparently, Congress is willing to distinguish between donative charities and commercial charities.

Congress also might scrutinize tax-exempt organizations in contexts other than unrelated business activities. For instance, concern is growing over the involvement of tax-exempt organizations in leveraged buy-outs and other high-risk deals. As colleges, universities, and their supporting organizations invest their endowment dollars in various forms of leveraged loans with the money used to fund risky corporate restructurings, inquiry may result in new laws concerning investment practices of tax-exempt entities.

163. As of June 1, 1989, revisions to the unrelated business income tax provisions of the Code remain stalled in the House Ways and Means Subcommittee on Oversight. Although Ways and Means Committee Chairman Dan Rostenkowski requested the Subcommittee to make its recommendations prior to the congressional Easter recess, *see* Daily Exec. Rep. No. 34 (BNA), at G-6 (Feb. 22, 1989), no recommendations have emerged from the Subcommittee. In a speech before the Business Coalition for Fair Competition, Representative Richard T. Schulze, a Pennsylvania Republican, ranking minority member of the Oversight Subcommittee, predicted that no major changes to the unrelated business income tax provisions would be enacted this year. *See* 50 Daily Exec. Rep. No. 50 (BNA), at G-6 (Mar. 16, 1989). Although suggestions have reportedly been made to Representative Rostenkowski and Subcommittee Chairman J.J. Pickle to drop some of the more controversial provisions of Representative Pickle's proposal submitted to the Subcommittee last year — such as aggregation, royalties, and advertising — and thereby to move the balance of the proposals forward, no compromise has been reached to get the proposals out of the Subcommittee. *See* Daily Exec. Rep. No. 52 (BNA), at G-6 (Mar. 20, 1989). Senator Robert Packwood, ranking minority member of the Senate Finance Committee, also stated that unrelated business income was not a high priority in the Senate and would not be taken up in the Senate until the House agreed upon legislation. *See* Daily Exec. Rep. No. 89 (BNA), at G-2 (May 10, 1989). Speaking at American Society of Association Executives Conference on May 9, 1989, Ways and Means Committee member Representative Charles B. Rangel, a New York Democrat, recently stated that unrelated business income was not an issue that raised revenue and he did not expect any legislative action on UBIT this year. *See Nonprofits Expected to Excape UBIT Reform This Year*, 43 TAX NOTES 783 (May 15, 1989). Speaking on May 19, 1989, at Georgetown University, Senate Finance Committee tax counsel, Maurice F. Foley, indicated that chances of Congress approving UBIT legislation this year, while never particularly strong, appear to be fading. *See Finance Counsel Downplays Possibilities of UBIT Reform*, 43 TAX NOTES 1079 (May 29, 1989). On August 2, 1989, Subcommittee Chairman Pickle reportedly asked Subcommittee members to reconvene in September 1989 to work toward developing a package of proposals for the House Ways and Means Committee.

V. Conclusion

Nonprivate, section 501(c)(3) foundations constitute a major, if not critical, support base for higher education. For the third time in almost forty years, Congress is addressing the question of competition between tax-exempt organizations and the for-profit sector. Colleges, universities, and their supporting foundations are no longer in the shadow cast by attention focused on hospital reorganizations. Now, all nonprofit organizations share the spotlight. The media's continuing scrutiny of the university-foundation relationship has been coupled with major cutbacks in federal assistance, federal and state governments' growing need for additional sources of revenue, the consequences of the Deficit Reduction Act, the controversy surrounding the televangelism sector, and charges by the small business community regarding perceived unfair competition.

The Treasury and IRS generally agree that before major changes in the law occur, the IRS must increase surveillance, auditing, information reporting, and data collection, as well as encourage general compliance with existing law. While these two bodies are formulating and implementing policy, Congress is considering legislation that will no doubt result in greater restrictions and limitations on the activities of tax-exempt organizations.

This is the climate in which colleges, universities, and their supporting foundations must operate for the foreseeable future.

APPENDIX

The following is the text of the Preliminary Discussion Options released March 31, 1988, by the House Subcommittee on Oversight:

"I. **'Substantially Related' Test:**

Repeal 'substantially related' test and replace it with a 'directly related' test.

Determine whether each income-producing activity standing alone is tax-exempt.

Retain 'substantially related' test; however, impose UBIT on specified activities (as listed in A-L below) whose nature and scope are inherently commercial, rather than charitable.

A. Apply UBIT to gift shop/bookstore income [with exceptions for (1) on-premise sales of low-cost mementos, (2) on-premise sales of an educational nature which relate to the organization visited, (3) in the case of a hospital, articles generally used by or for inpatients, (4) in the case of a university, articles in furtherance of educational programs, or low-cost items (dollar cap), and computer sales not in excess of one sale per student/faculty per year].

In addition, apply UBIT to income from all catalog and mail/phone order or other 'off-premise' sales (with exception for de minimis sales, in relation to amount of 'on-premise' sales).

B. Apply UBIT to all sales or rental income of medical equipment and devices (including hearing aids, portable x-ray units, oxygen tanks), laboratory testing, and pharmaceutical drugs and goods (with exceptions for (1) inpatients, continuous-care outpatients, or emergency treatment outpatients or (2) items not available in immediate geographic area.)

C. Apply UBIT to income from certain health, fitness, exercise and similar activities unless program is available to a reasonable cross-section of the general public such as by scholarship or fees based on community affordability.

D. Apply UBIT to travel and tour services (with exception for services provided by colleges/universities to students/faculty as part of a degree program curriculum, and de minimis sales to non-students/faculty).

E. Apply UBIT to adjunct food sales (with exception for on-premise services and/or sales provided primarily for students, faculty, employees, members, or organization visitors).

F. Apply UBIT to income from certain veterinary services such as grooming, boarding, and elective surgery (with exceptions for spaying and neutering, measures to protect the public health, and measures recommended by a veterinarian for the health of the animal).

G. Apply UBIT to hotel facility income which is patronized by the public (with exception for facilities operated, but only to the extent necessary, in furtherance of the organization's exempt purpose).

In addition, apply UBIT to certain sales of condominiums and time-sharing units.

H. Apply UBIT to routine testing income (with exceptions for Federal or State mandated activity, pre-surgical medical testing, and laboratory testing which is part of a student educational training program).

I. Apply UBIT to income from affinity credit card/catalog endorsements.

J. Apply UBIT to advertising income and allow deductions from UBIT only for direct advertising costs.

K. Apply UBIT to theme/amusement parks.

L. Apply UBIT to additional specified activities determined to be inherently commercial.

II. Convenience Exception:

Repeal 'convenience' exception (income from activities carried on primarily for the convenience of a Section 501(c)(3) organization's members, students, patients, officers, or employees).

Income from activities that are substantially related to the organization's exempt purpose would remain tax free, subject to the specific rules listed in Section I. above.

III. 'Regularly Carried On' Test:

Repeal 'regularly carried on' test.

Income from an activity that is not a trade or business would remain tax-free.

IV. Tax Treatment of Royalty Income:

Apply UBIT to royalties measured by net or taxable income derived from the property; or royalties received by an organization for use of property if such organization, or closely related organization, either: (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

Retain present law for certain non-working property interests, and exceptions for products that are part of the organization's exempt function.

V. Deduction from Taxable UBIT:

Increase $1,000 UBIT deduction for certain Section 501(c) organizations to $5,000 or $10,000, with phaseout beyond $50,000 income level. Limit the increased deduction to activities directly carried on by the exempt organization.

VI. Unrelated Debt-Financed Income:

Limit the current law UBIT exception for unrelated debt-financed property to only those pension funds, educational institutions and title holding companies that make at least a 20 percent equity investment of their interest in the property.

Retain character of debt-financed income received from all pass-through entities.

VII. Subsidiaries and Joint Ventures:

Modify the definition of 'control' in the case of exempt organizations having taxable subsidiaries. Define 'control' as ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value (rather than 80 percent of combined voting stock, under present law).

Extend 'control' rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock.

Provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization.

Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of parent is a tax-exempt purpose.

VIII. Allocation Rules:

With respect to facilities used for exempt purposes as well as unrelated business purposes, allow a deduction against UBI for a proportionate share of the direct operating cost of the facility (e.g., maintenance, insurance, and utilities), but not allow a deduction for a share of the general overhead of the organization or for depreciation.

IX. Tax Information Reporting/Internal Revenue Service (IRS) Administration:

Expand Form 990-T reporting requirement to include more reporting on: (1) activities and income which the organization claims to be exempt or excluded from UBIT, and (2) revenue sources such as contributions, grants or other funding sources.

Provide more detailed reporting of revenue-producing activities and income on Form 990.

Consider 'short form' reporting for small organizations, based on revenues.

Require affiliated group that includes an exempt organization to file a consolidated information return.

Recommend that IRS have an integrated examination program for exempt organizations and subsidiaries (taxable and exempt).

Recommend that IRS conduct the following studies and report on: (1) nonprofit exempt hospital reorganizations (examining the extent, purpose, effect of the use of subsidiaries); (2) exempt organizations that file Form 990s but do not file Form 990-T's (examining activities of a sample group to determine compliance with UBIT); (3) the feasibility of requiring State and Federal land-grant universities to file an information return; (4) the use, purpose and effect of joint ventures; and, (5) study, after five years, on effect of UBIT changes.

X. **Miscellaneous:**

Codify IRS position (upheld by some courts) that a social club (or other organization whose investment income is subject to UBIT) may not, in determining UBIT, reduce its net investment income by losses on sales to non-members.

Exempt from UBIT an organization's contingent rental income received through a prime tenant, where the prime tenant leases real estate from a tax-exempt organization, the prime tenant's net profits are based on fixed rents derived from subtenants, and the prime tenant does not provide services to subtenants except through an independent contractor.

Exempt from UBIT investment income earned from nonrefundable loan commitment fees.

Modify rules applicable to organizations 'testing for the public safety.'

Consider modification of various piecemeal UBIT exclusions enacted since 1969."