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## Taxing Nonprofits out of Business

Diane L. Fahey

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# Taxing Nonprofits out of Business

Diane L. Fahey\*

## *Abstract*

*In the last twenty years, the number of nonprofit organizations has exploded; there are more than 1.2 million organizations registered with the Internal Revenue Service. Donations and government grants have decreased, while at the same time, nonprofits are facing increasing demands on their services. As a result, nonprofit organizations have been forced to devise new strategies for acquiring funds.*

*Some nonprofit organizations have resorted to renting their mailing lists to businesses and other nonprofit organizations and have licensed their names and logos to be displayed on affinity credit cards offered by banks to consumers. Nonprofit organizations have argued that these funds are not subject to the unrelated business income tax and consider them to be exempt as royalties. The Internal Revenue Service, and initially the courts, disagreed.*

*Revenue from these two sources should continue to be classified as royalty income. These royalties operate in a fashion analogous to traditional mineral rights royalties, which are exempt from the unrelated business income tax. Mineral rights royalties are divided into a taxable working interest, which bears the risks and benefits of the venture, and the exempt investment interest held by the nonprofit. These new royalties can be divided the same way into these two interests. In fact, it can be argued that this approach could be applied to other income items to determine if they should be exempt from the unrelated business income tax.*

*Further, mailing list rentals and affinity credit card licenses do not contain even the potential to harm competition. However, taxing this income may*

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*well hinder certain nonprofits from functioning and discriminate in favor of older, more moneyed organizations.*

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### I. Introduction

Imagine a not-for-profit organization, such as a law school, organized to engage in the charitable purpose of providing education for students. Assume that, under federal tax law, neither tuition revenues nor contributions to the school are taxed to the school. What if that school also was to run an unrelated commercial business, such as a macaroni factory? If it was not taxed on the revenue from that company, the law school's macaroni company would have a competitive advantage over other similar companies, shrinking their profit margins and perhaps driving them out of business.

This hypothetical may seem unrealistic, but it is grounded in reality. In the 1940s, a group of individuals wished to benefit New York University, which had a small endowment, a large enrollment, and needed additional funds to cover its costs.<sup>1</sup> These benefactors donated the stock of the C.F. Mueller Co. to New York University.<sup>2</sup> At the time, C.F. Mueller was the country's largest manufacturer of macaroni.<sup>3</sup>

In addition to the C.F. Mueller Co., New York University acquired three other companies: Howes Leather Company; American Limoges China, Inc.; and the Ramsey Corporation, a piston ring manufacturer.<sup>4</sup> New York University was not alone. After World War II, a number of colleges acquired commercial real estate that included department stores, warehouses, office buildings, and apartment buildings.<sup>5</sup> Frequently, these colleges acquired the real estate by borrowing the purchase price and then repaying the loan with the tax-free rental income.<sup>6</sup>

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1. See *C.F. Mueller Co. v. Comm'r*, 14 T.C. 922, 923 (1950) (describing briefly the university's financial condition).

2. *Id.* at 923–25 (explaining how the benefactors donated the stock to the university).

3. Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280, 1281 (1968).

4. See Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 FLA. TAX REV. 367, 382 (1996) (outlining New York University's acquisition of these three businesses).

5. See *id.* at 382–83 (explaining how colleges and universities regularly acquired such companies).

6. See *id.* (explaining how educational organizations financed these purchases); *Estate of Howes v. Comm'r*, 30 T.C. 909, 911–15 (1958) (describing New York University's acquisition of Howes Leather Co. and its use of debt to finance the purchase).

By 1950, the public outcry over nonprofit organizations' commercial activities galvanized Congress to take action.<sup>7</sup> New York University's activities were particularly troubling to certain members of Congress, causing Representative John Dingell to warn that unless action was taken, "the macaroni monopoly will be in the hands of the universities . . . . Eventually all the noodles produced in this country will be produced by corporations held or created by universities."<sup>8</sup>

While the Revenue Act of 1950, containing the proposed unrelated business income tax provisions,<sup>9</sup> was pending, Congress held hearings and heard testimony from both the business community and representatives from colleges and universities.<sup>10</sup> Subsequently, the provisions were enacted and are still a part of the Internal Revenue Code (I.R.C. or Code).<sup>11</sup> Thus, today, a law school that started or acquired a macaroni company would have to pay tax on the pasta profits, much as a commercial enterprise would.

Since then, nonprofit organizations have engaged in other activities that are harder to classify as "business" in the sense the drafters of the 1950s' legislation conceived it. In recent years some nonprofits have availed themselves of two increasingly popular means for raising funds: (1) renting their donor mailing lists to commercial and other nonprofit organizations and (2) licensing the organization's name and logo to banks that issue credit cards bearing that name and logo (affinity cards).<sup>12</sup>

This is not an insignificant or unimportant issue. Within the last twenty years, the number of nonprofit organizations has burgeoned. As of 1995, there were approximately 1.2 million groups registered with the Internal Revenue Service.<sup>13</sup> Their numbers include the Salvation Army, the United Ancient Order of Druids, Toastmasters, the Oilfield Chili Appreciation Society, Alcoholics Anonymous, the Assembly of Wicca, Cleveland Clinic Hospital, the

7. See Note, *supra* note 3, at 1281 (explaining how the Mueller Co. situation prompted Congress to act).

8. *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong. 579-80 (1950) [hereinafter *Hearings Before House Comm.*].

9. Revenue Act of 1950, Pub. L. No. 64-814, §§ 301, 331, 64 Stat. 906, 947, 957, (codified as amended at I.R.C. §§ 502-514 (1954)).

10. See generally *Hearings Before House Comm.*, *supra* note 8.

11. I.R.C. §§ 511-513 (2000).

12. See *infra* Part III.B (explaining how a typical affinity card program works).

13. Alicia Meckstroth & Paul Arnsberger, *20-Year Review of the Nonprofit Sector, 1975-1995*, STATISTICS OF INCOME BULLETIN, Fall 1998, at 150, available at <http://www.irs.gov/taxstats/article/0,,id=117505,00.html> (on file with the Washington and Lee Law Review).

Red Cross, and the Columbia Ultimate Frisbee Association.<sup>14</sup> In 1995, the 307,384 exempt organizations that filed tax returns reported \$1.6 trillion in assets and more than \$8 billion in revenues.<sup>15</sup> In 1997, only 19.9% of the nonprofit sector's funds came from private contributions; fees for services, government grants, and profits from sales and investments accounted for the balance of the revenue.<sup>16</sup>

For years, small businesses in particular have complained about the increasingly commercial activities of nonprofits.<sup>17</sup> In 2000, exempt organizations reported gross unrelated business income of \$8.4 billion and unrelated business taxable income of \$1.4 billion on which they paid taxes of \$405.8 million.<sup>18</sup> With the recent scandals involving charities that were established in the wake of September 11th and charities established for tax avoidance purposes, Congress once again is subjecting nonprofits' activities to closer scrutiny.<sup>19</sup> Congress may consider expanding the scope of the unrelated business income tax to include income from mailing list rentals and affinity card licensing activities.<sup>20</sup>

This Article argues that contrary to how it may seem at first blush, subjecting mailing list rental and affinity card income to the unrelated business

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14. INTERNAL REVENUE SERVICE, IRS PUBLICATION 78, CUMULATIVE LIST OF § 501(c)(3) ORGANIZATIONS (2004).

15. MARGARET RILEY, UNRELATED BUSINESS INCOME OF NONPROFIT ORGANIZATIONS: HIGHLIGHTS OF 1995 AND A REVIEW OF 1991-1995, at 171 (1999). Dollar amounts are adjusted to reflect constant dollars.

16. VIRGINIA A. HODGKINSON ET AL., THE NEW NONPROFIT ALMANAC AND DESK REFERENCE 156, 159, 190 (2002) (setting out the sources of income for the nonprofit sector in 1997).

17. See *Owens Discusses Unrelated Business Income Issues, Restructuring*, TAX NOTES TODAY, Apr. 26, 1999, LEXIS, 1999 TNT 79-2 (discussing small business complaints about nonprofit commercial activities). See generally Carolyn D. Wright, *Tide Could Be Shifting on IRS Pursuit of Affinity Card UBI*, 20 EXEMPT. ORG. TAX REV. 203 (May 1998) (outlining briefly Owens's speech).

18. See Margaret Riley, *Unrelated Business Income Tax Returns, 2000, with a Decade in Review, 1991-2000*, IRS STAT. OF INCOME BULL., Spring 2004, at 135-37 (summarizing tax figures from fiscal year 2000). The \$405.8 million in unrelated business income tax is adjusted for certain credits and other taxes, resulting in \$402.9 million in total tax. *Id.*

19. *Today's Tax Highlights*, TAX NOTES TODAY, June 23, 2004, LEXIS, 2004 TNT 121-H (summarizing Internal Revenue Service Commissioner Mark Everson's appearance before the Senate Finance Committee, and recounting some of the abusive practices that have been discovered, such as excessive compensation to executives, and "charity involvement in transactions that benefit taxable entities").

20. *Today's Tax Highlights*, TAX NOTES TODAY, July 2, 2004, LEXIS, 2004 TNT 128-8 (recounting reports from aides to the Senate Finance Committee that the Committee is preparing to work on legislation that would establish reforms for nonprofits based on recommendations contained in a discussion draft of proposed reforms).

income tax will not protect competition, but may well cause hardship for tax-exempt organizations that are unable to fund fully their activities from traditional sources of revenue such as donations and fees. This Article argues that, if these activities constitute the operation of a trade or business, they do not pose a threat to competition and therefore should remain exempt from the unrelated business income tax.

Following this introduction, Part II explains how the unrelated business income tax operates, recounts the events that led to its enactment, and surveys the various attempts to define "trade or business" and the difficulties in applying that term to the nonprofit sector. Part III traces the courts' progression from subjecting affinity card and mailing list rental to taxation as income derived from a trade or business to income exempt from taxation as a royalty. Part IV considers how the exemption for royalties derived from mineral rights can be applied by analogy to income derived from these activities. Finally, Part V examines how these activities neither divert a nonprofit's resources from its exempt purpose nor cause harm to competition. Therefore, the Article concludes that these activities should not be subject to the unrelated business income tax.

## *II. Charities, Unrelated Business, and Taxation*

### *A. I.R.C. Sections 511–513: How They Operate*

I.R.C. Section 511 states that a tax will be imposed on the unrelated business income of tax-exempt organizations.<sup>21</sup> I.R.C. Section 512(a) defines "unrelated business taxable income" as the gross income derived by an exempt organization from the operation of an unrelated trade or business, less deductions allowed, and subject to certain modification contained in I.R.C. Section 512(b), discussed below.<sup>22</sup> I.R.C. Section 513(a) defines an "unrelated trade or business" as (1) any trade or business, (2) regularly carried on, (3) the conduct of which is not substantially related to the organization's exempt purpose.

An exempt organization may obtain revenues from donations or fees such as admission charges to a museum or college tuition. These revenue sources are not taxable because the exempt organization derives them as a result of fulfilling its exempt purpose. In addition, an exempt organization may obtain revenues from carrying on a trade or business that is related to its exempt

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21. See I.R.C. § 511 (2000) (stating that unrelated business income will be taxed).

22. See *id.* § 512(a)(1) (defining unrelated business taxable income).

purpose.<sup>23</sup> For example, an exempt organization may be formed to assist homeless persons in obtaining skills so that they will become capable of supporting themselves financially. To accomplish this goal, the organization may operate a restaurant that is completely staffed by the homeless individuals who are responsible for food preparation, cashing, and food service. The business may earn a profit, but its primary purpose is not to raise money, but to help homeless individuals become employable. Therefore, any net profit that the restaurant earns is not subject to the unrelated business income tax.

An exempt organization may also choose to operate an unrelated trade or business. If the business is regularly carried on and is not operated for the primary purpose of furthering the organization's exempt purpose (other than its need for funds), it is subject to taxation unless an exception applies. In order for I.R.C. Section 513 to apply, however, the trade or business must be both regularly carried on and unrelated.<sup>24</sup> For example, a group of citizens may form a civic booster club to place welcome signs and flower boxes at entrances to their city. To pay for the signs and flower boxes, the civic booster club might hold a bake sale at a local church twice a year. The bake sale is a trade or business not related to the booster group's exempt purpose (beautifying the city), but it is not regularly carried on and therefore not subject to I.R.C. Section 513. However, if the civic club were to hold a bake sale every day, it would be regularly operating the trade or business of a bakery, and the profits would be subject to the unrelated business income tax.

I.R.C. Section 512(a) provides that the term unrelated business taxable income is the gross income derived by an organization from the operation of an unrelated trade or business, subject to certain modifications or exclusions contained in I.R.C. Section 512(b).<sup>25</sup> The most significant exclusions are dividends, interest, certain real estate rentals, annuities, and royalties.<sup>26</sup>

### *B. The Judicially Created Destination of Income Test and Congress's Response*

In order to understand why mailing list rental and affinity card income should not be subject to the unrelated business income tax, one needs to explore Congress's reasons for enacting the tax and the abuses it was

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23. See *id.* § 513(a)(2) (providing an exception to the tax in Section 511).

24. See *id.* § 513(a) (determining when this section applies).

25. See *id.* § 512(a)(1) (defining unrelated business taxable income).

26. See *id.* § 512(b)(1)–(3) (setting forth the primary modifications and exclusions).



intended to address and remedy. Nonprofit organizations have not always been subject to tax on revenues derived from business activities unrelated to their exempt functions. Since the earliest Europeans established settlements in North America, supporting charitable endeavors has been a part of our societal framework, and part of that support has been in the form of exempting nonprofit organizations from tax.<sup>27</sup> After the American Revolution, Massachusetts, Pennsylvania, Vermont, and New Hampshire provided for the protection of charities in their respective state constitutions.<sup>28</sup> Other states enacted statutes to support and to encourage charities, and charities continued to enjoy a preferred tax status after passage of the Sixteenth Amendment and the first constitutional federal income tax.<sup>29</sup>

The Tariff Act of 1913<sup>30</sup> exempted from taxation any corporation "organized and operated exclusively for religious . . . purposes, no part of the net income of which inures to the benefit of any private stockholder or individual."<sup>31</sup> The Act did not draw any distinction between revenues derived from activities related to the nonprofit organization's exempt purpose and unrelated activities.<sup>32</sup> After enactment of the Act, the Supreme Court decided *Trinidad v. Sagrada Orden de Predicadores*<sup>33</sup> and created the destination of income test for nonprofits.<sup>34</sup> In *Sagrada*, the revenue agent for the Philippine Islands assessed an income tax against a religious order that operated missions in Southeast Asia on the ground that the order had obtained funds from the operation of a trade or business.<sup>35</sup> The religious order derived the bulk of its income from rents, dividends, interest, and gains from the occasional sale of stock.<sup>36</sup> The order also derived a relatively modest amount of income from the sale of wine, chocolates, and other miscellaneous items to its churches, missions, and other agencies for their own use.<sup>37</sup> The Philippine revenue agent

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27. See ROBERT H. BREMMER, *AMERICAN PHILANTHROPY* 5–18 (2d ed. 1988) (outlining the history of tax exemptions for charities in early America).

28. JAMES J. FISHMAN & STEPHEN SCHWARZ, *TAXATION OF NONPROFIT ORGANIZATIONS* 29–30 (2003) (observing that these four states protected charities in their constitutions).

29. *Id.* at 30 (noting that some states affirmed the benefits of charities through statutes).

30. Act of Oct. 3, 1913, Pub. L. No. 38-16, 38 Stat. 114 (repealed 1916).

31. *Id.* at 172.

32. See *id.* (drawing no distinction between the organization's purpose and activities).

33. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

34. *Id.* at 581.

35. See *id.* (stating that the defendant argued that the plaintiff was operated for "business and commercial purposes" and this was not within the exception).

36. See *id.* at 580 n.1 (showing that the order received 240,948.23 pesos from these sources).

37. See *id.* (showing that the order received 13,654.16 pesos from these sales).

argued that the religious order was not organized and operated exclusively for charitable purposes because it was engaging in the business of selling wine and chocolate.<sup>38</sup> In other words, although the order used the funds for religious purposes, the revenue agent assessed a tax because the order had obtained the funds from commercial activities and not from the operation of its exempt purpose.

The United States Supreme Court held that the income was incidental in amount but, more importantly, that the statute did not make any reference to the source of the funds used by the charitable organization; it focused exclusively on the destination of the funds.<sup>39</sup> If the funds, however derived, were used exclusively for charitable purposes, the funds were not subject to tax. In the instant case, there was no indication that the religious order's income was used for any purpose other than charity.<sup>40</sup>

The destination of income test received further reinforcement from the decision of the Court of Appeals for the Second Circuit in *Roche's Beach, Inc. v. Commissioner*,<sup>41</sup> decided under the tax code in effect in 1928.<sup>42</sup> Edward Roche made provision in his will for the formation of a corporation to operate a beach-bathing business that was obligated to turn over the net proceeds to a charitable organization Roche established to assist indigent persons.<sup>43</sup> The beach-bathing business rented bathhouses, towels, and suits, and sold concessions to the public.<sup>44</sup> The Second Circuit relied on *Sagrada* in support of its position that "the destination of the income is more significant than its source."<sup>45</sup> The Second Circuit held that the destination of income test applied even when the income was not earned by the nonprofit organization itself but also where the source of the funds was a related taxable entity, such as a subsidiary that, in turn, funneled the funds to the nonprofit organization.<sup>46</sup> The

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38. *See id.* at 581 (summarizing the agent's arguments).

39. *See id.* (explaining that the "destination [of the income is] the ultimate test of exemption").

40. *See id.* (concluding the income from the properties was devoted exclusively to the religious, charitable, and educational functions and that the trading is not a "distinct or external venture").

41. *Roche's Beach, Inc. v. Comm'r*, 96 F.2d 776 (2d Cir. 1938).

42. I.R.C. § 103(6), (14) (1928).

43. *See Roche's Beach*, 96 F.2d at 776-77 (outlining the formation, assets, and purpose of this corporation).

44. *See id.* at 777 (explaining how the corporation generated income).

45. *Id.* at 778.

46. *See id.* at 779 (stating that Congress intended for the exemption to apply both to corporations that "administer the charity" and to corporations "organized and operated exclusively to feed a charitable purpose").

court held that as long as the nonprofit organization used the funds for a tax-exempt purpose, the income was not subject to tax.<sup>47</sup>

The destination of income test began to generate controversy when an increasing number of exempt organizations began operating wholly owned commercial businesses.<sup>48</sup> As mentioned earlier, the most contentious was New York University's ownership of the C.F. Mueller Co., a New Jersey corporation and the largest manufacturer of macaroni products in the 1940s.<sup>49</sup> New York University's benefactors formed a Delaware corporation that purchased all of the stock of the New Jersey C.F. Mueller Co. and merged it into the Delaware corporation.<sup>50</sup> The stock of the new Delaware corporation would be donated to New York University after ten years.<sup>51</sup> The Internal Revenue Service assessed a tax on C.F. Mueller Co.'s income, and C.F. Mueller Co. objected and filed suit in the Tax Court.<sup>52</sup>

The Tax Court ruled against C.F. Mueller Co., stating that the destination of income test should not be "stretched and distorted" to cover situations that were not originally contemplated by the United States Supreme Court when *Sagrada* was decided, nor by other courts in later cases because "[s]uch use of business corporations is relatively new, born principally of the necessity for colleges to obtain more income than the return theretofore received on their funds available for investment."<sup>53</sup> The Tax Court also refused to follow the reasoning of *Roche's Beach*.<sup>54</sup>

The Court of Appeals for the Third Circuit overruled the decision of the Tax Court<sup>55</sup> on the ground that prior case law, including *Roche's Beach*, established that if the destination of the income was for charitable purposes, the income was not subject to tax.<sup>56</sup> The appellate court noted that Congress

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47. See *id.* (saying that income used for tax-exempt purposes is covered by the exemption).

48. See Sharpe, *supra* note 4, at 381–83 (discussing cases and examples involving the destination of income standard).

49. Note, *supra* note 3, at 1281.

50. C.F. Mueller Co. v. Comm'r, 14 T.C. 922, 923–24 (1950), *rev'd*, 190 F.2d 120 (3d Cir. 1951).

51. *Id.* at 925.

52. *Id.* at 923.

53. *Id.* at 927.

54. *Id.* at 928.

55. C.F. Mueller Co. v. Comm'r, 190 F.2d 120, 123 (3d Cir. 1951).

56. See *id.* at 121 (summarizing what is needed to meet the statutory requirements by referencing prior cases).

reenacted the pertinent tax code sections several times without change prior to the *C.F. Mueller Co.* litigation, lending further support to the application of the destination of income standard.<sup>57</sup>

### C. Congressional Response to the Destination of Income Test

By 1950 the public outcry over nonprofit organizations' commercial activities galvanized Congress to take action.<sup>58</sup> While the Revenue Act of 1950, which contained the proposed unrelated business income tax provisions,<sup>59</sup> was pending, Congress held hearings and heard testimony from both the business community and representatives from colleges and universities.<sup>60</sup> Congress's main goal in enacting the unrelated business income tax was to prevent unfair competition.<sup>61</sup> However, raising revenue was another important consideration: Congress wished to repeal various excise taxes that had been imposed to fund World War II, but the escalating conflict in Korea created a need for more revenue.<sup>62</sup> In addition, Congress was concerned about nonprofits diverting their resources from their exempt purposes towards commercial activity.<sup>63</sup> Both the House Ways and Means Committee Report and the Senate Finance Committee Report noted these considerations underlying the proposed enactment of the unrelated business income tax: "Military action in Korea coupled with substantial increases in defense and related expenditures has made it necessary to convert the excise tax reduction bill passed by the House in June of this year into a bill to raise revenues."<sup>64</sup>

The House bill imposed the regular corporate income tax on certain tax-exempt organizations that are in the nature of corporations, and the individual income tax on tax-exempt trusts, with respect to so much of their income as arises from active business enterprises that are unrelated to the exempt purposes of the organizations.<sup>65</sup>

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57. *Id.* at 122-23.

58. *See Note, supra* note 3, at 1281 (stating that the *C.F. Mueller Co.* gave Congress "a reason to tax charity-owned businesses").

59. *See generally* Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947, 957 (codified as amended at I.R.C. §§ 502-514 (1954)).

60. *See generally Hearings Before House Comm., supra* note 8.

61. H.R. REP. NO. 81-2319, at 36 (1950).

62. *See* S. REP. NO. 81-2375, at 1 (1950) (asserting that military and defense expenses required the conversion of the excise tax reduction bill to become a revenue increasing bill).

63. *Id.*

64. *Id.*

65. *Id.* at 27.

The problem to which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of these Section 101 organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.<sup>66</sup>

President Truman also shared Congress's concerns and sent a written message to Congress outlining his tax policy views and concerns.<sup>67</sup> President Truman specifically raised the issue of nonprofits' commercial activities and expressed his concern that such activity reduced federal revenues, improperly diverted nonprofits' resources, and created unfair competition:

Some tax loopholes have also been developed through the abuse of the tax exemption accorded educational and charitable organizations. It has properly been the policy of the Federal Government since the beginning of the income tax to encourage the development of these organizations. That policy should not be changed. But the few glaring abuses of the tax-exemption privilege should be stopped.

Responsible educational leaders share in the concern about the fact that an exemption intended to protect educational activities has been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial operations entirely unrelated to educational activities.

There are also instances where the exemption accorded charitable trust funds has been used as a cloak for speculative business ventures, and the funds intended for charitable purposes, buttressed by tax exemption, have been used to acquire or retain control over a wide variety of industrial enterprises.<sup>68</sup>

Although the colleges and universities acquiesced in taxing nonprofits' unrelated business income, they were adamant that certain commercially derived revenues, such as dividends and interest, remain exempt, and Congress agreed. The House Ways and Means Committee report discussed the exceptions to the unrelated business income tax contained in I.R.C. Section 512(b):

The tax applied to unrelated business income does not apply to dividends, interest, royalties, (including, of course, overriding royalties), rents (other than certain rents on property acquired with borrowed funds), and gains from sales of leased property. Your committee believes that such "passive"

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66. H.R. REP. NO. 81-2319, at 36 (1950).

67. See generally President's Message to Congress, 96 CONG. REC. 769 (1950).

68. *Id.* at 771.

income should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations.<sup>69</sup>

The unrelated business income tax provisions did not define trade or business or royalty,<sup>70</sup> paving the way for disputes. Although Congress was concerned about unfair competition, it enacted a statute that dealt with unrelated trade or businesses. Congress apparently conflated unfair competition and unrelated businesses, but the two concepts are not conterminous. For example, related businesses can compete with and possibly harm commercial entities.<sup>71</sup>

#### D. What Is a Trade or Business?

Taxpayers may derive income not only from the operation of a trade or business, but from other sources, such as investments, gifts, or hobbies. The source of income matters because some income is not included in gross income at all; other income may not be offset by deductions.<sup>72</sup> According to the Supreme Court in *Commissioner v. Groetzinger*,<sup>73</sup> "not every income-producing and profit-making endeavor constitutes a trade or business."<sup>74</sup> For a commercial enterprise, the distinction usually does not matter—virtually all activity is deemed to be a trade or business;<sup>75</sup> however, the distinction does matter for individual taxpayers and nonprofits. In *Higgins v. Commissioner*,<sup>76</sup> an individual taxpayer had extensive investments to which he devoted a "considerable portion of his time" overseeing and for which he incurred

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69. H.R. REP. NO. 81-2319, at 38 (1950). For a more detailed chronology of the unrelated business income tax's enactment, see Judge Tannenwald's opinion in *University Hill Foundation v. Commissioner*, 51 T.C. 548, 561-66 (1969).

70. See generally Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947, 957 (codified as amended at I.R.C. §§ 502-514 (1954)).

71. See generally Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982).

72. For example, I.R.C. § 102 excludes gifts from gross income, and I.R.C. § 83 permits a taxpayer to deduct expenses incurred in the pursuit of a hobby only up to the amount of income earned from the hobby. I.R.C. §§ 83, 102 (2000).

73. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

74. *Id.* at 35.

75. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 5.03[1] (6th ed. 1999) (stating that the Code assumes that all transactions for the benefit of the corporation's interests arise in the corporation's trade or business).

76. *Higgins v. Comm'r*, 312 U.S. 212 (1941).

substantial expenses, such as office rental space and salaries for employees he hired to assist him.<sup>77</sup> The Supreme Court indicated that an individual taxpayer cannot deduct expenses incurred while managing personal investments, but rather only those expenses incurred from a trade or business.<sup>78</sup> Immediately afterward, Congress enacted I.R.C. Section 212 to permit individual taxpayers to deduct their investment expenses.<sup>79</sup>

Nevertheless, for individual taxpayers the distinction between a trade or business, as opposed to investment activity, still matters because trade or business expenses may be deducted directly from the gross income derived from the trade or business.<sup>80</sup> That same taxpayer only may deduct investment expenses if the taxpayer itemizes deductions in lieu of the standard deduction and only if a certain monetary threshold is met.<sup>81</sup> Therefore, individual taxpayers, as opposed to commercial enterprises, must determine whether income-generating activity is a trade or business on the one hand or investment on the other.

Most nonprofits are operated in corporate form,<sup>82</sup> however, unlike a commercial corporation where revenue presumably arises from the operation of a trade or business,<sup>83</sup> nonprofit corporations presumably generate their income from noncommercial activity, such as donations, fee service income, or government grants. In other words, the presumed norm is that the nonprofit corporation does not engage in activities for profit, but rather to fulfill its exempt purpose. Some nonprofits, however, operate trades or businesses that are unrelated to their exempt purpose. I.R.C. Section 512(b) then exempts revenues derived from dividends, interest, royalties, and certain rents from the unrelated business taxable income.<sup>84</sup> Therefore, just as with individual

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77. *Id.* at 213.

78. *See id.* at 217–18 (upholding the decision by the Board of Tax Appeals that the activities of the petitioner did not qualify as "carrying on a business").

79. Revenue Act of 1942, Pub. L. No. 77-753, § 121, 56 Stat. 798, 819.

80. I.R.C. §§ 62(a)(1) and 162(a) permit taxpayers to deduct "above the line" expenses incurred from operating a trade or business. In other words, the taxpayer will get the benefit of the deduction because the taxpayer may deduct the expenses directly against the gross income to calculate adjusted gross income. I.R.C. §§ 62(a)(1), 162(a) (2000).

81. I.R.C. § 212 permits a taxpayer to deduct as an itemized deduction investment expenses. I.R.C. § 63(d) allows the taxpayer to deduct itemized deductions in lieu of the standard deduction; therefore, the taxpayer will only itemize deductions if the total amount exceeds the standard deduction. I.R.C. §§ 67 and 68 impose additional limits on the amount that the taxpayer may deduct. *Id.* §§ 63(d), 67, 68, 212.

82. *See Henry Hansmann, The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 840 (1980) (discussing the structure of nonprofit organizations).

83. BITTKER & EUSTICE, *supra* note 75, ¶ 5.03[1].

84. I.R.C. § 512(b) (2000).

taxpayers, nonprofit corporations must distinguish between trade or business income and other income, such as income derived from the sources listed in I.R.C. Section 512(b).<sup>85</sup> Additionally complicating matters for nonprofits, they must distinguish between unrelated and related businesses.<sup>86</sup>

During the past sixty years, neither Congress nor the courts have been able to fashion a general, all-inclusive definition of a trade or business.<sup>87</sup> However, the Supreme Court in *Groetzinger* noted that at times the Code will define the term for a limited purpose.<sup>88</sup> In an oft-cited concurring opinion in *Deputy v. du Pont*,<sup>89</sup> Justice Frankfurter posited that a trade or business involved "holding one's self out to others as engaged in the selling of goods or services."<sup>90</sup> However, one year later the Supreme Court decided *Higgins v. Commissioner*.<sup>91</sup> Ignoring Justice Frankfurter's definition, the Court rather tersely stated that "[t]o determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."<sup>92</sup> Subsequent to *Higgins*, the lower courts struggled to determine whether a particular activity was a trade or business.<sup>93</sup> Various formulations were tried and discarded over the years, but no one definition or test has sufficed for all purposes.

85. *Id.*

86. *See id.* §§ 511–513 (imposing a tax on income derived from activities unrelated to the charitable purposes of the organization).

87. *See Comm'r v. Groetzinger*, 480 U.S. 23, 27 (1987) (concerning the lack of definition for trade or business). The majority stated:

The phrase "trade or business" has been in section 162(a) and in that section's predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations. . . . The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words "trade or business" for general application, and no regulation has been issued expounding its meaning for all purposes. Neither has a broadly applicable authoritative judicial definition emerged.

*Id.*

88. *Id.* at 27 n.6.

89. *Deputy v. du Pont*, 308 U.S. 488 (1940).

90. *Id.* at 499 (Frankfurter, J., concurring).

91. *Higgins v. Comm'r*, 312 U.S. 212 (1941).

92. *Id.* at 217.

93. *See, e.g., Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1187 (Ct. Cl. 1981) (stating that if an activity is conducted in a competitive, commercial manner, it is a trade or business); *Stanton v. Comm'r*, 399 F.2d 326, 329 (5th Cir. 1968) (opining that trade or business refers to "extensive activity over a substantial period of time during which the taxpayer holds himself out as selling goods or services").



In *Groetzinger*,<sup>94</sup> the Supreme Court adhered to its position in *Higgins* that the determination of whether an activity rises to the level of a trade or business is one of fact and explicitly rejected the notion of one all-encompassing test.<sup>95</sup> With regard to Justice Frankfurter's formulation in *Higgins*, the Court stated that "[w]e must regard the Frankfurter gloss merely as a two-Justice pronouncement in a passing moment and, while entitled to respect, as never having achieved the status of a Court ruling. . . . We therefore now formally reject the Frankfurter gloss which the Court has never adopted anyway."<sup>96</sup>

### *E. Statutory and Regulation Definitions of Unrelated Trade or Business*

I.R.C. Section 513(a) provides that an unrelated trade or business is one that is not related to the nonprofit organization's exempt purpose, but it does not define a trade or business for unrelated business income tax purposes.<sup>97</sup> In 1967 the Treasury Department promulgated the current regulations,<sup>98</sup> which attempt to define trade or business activity for purposes of the unrelated business income tax. Treasury Regulation Section 1.513-1(b) provides in pertinent part as follows:

(b) Trade or business. The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute *trade or business* within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents

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94. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

95. *Id.* at 36.

96. *Id.* at 32, 34.

97. I.R.C. § 513(a) (2000); *see Sharpe, supra* note 4, 414–18 (detailing the differing standards employed by the 1958 regulations and the 1967 regulations to distinguish between related and unrelated trades or businesses).

98. *Treas. Reg. § 1.513-1(b)* (1983); *see generally* Note, *supra* note 3 (discussing in detail the reasons that led to the enactment of the new regulations and the problems they were designed to remedy).

sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term *trade or business* has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.<sup>99</sup>

Treasury Regulation Section 1.513-1(b) defines a trade or business as having the "same meaning it has in I.R.C. Section 162, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services."<sup>100</sup> Parsing this definition does not reveal a coherent, readily ascertainable standard to assist the courts and nonprofit organizations as to which activities will be deemed a trade or business.

I.R.C. Section 162 provides little guidance because its primary purpose is to authorize deductions for a trade or business.<sup>101</sup> Section 162 allows deductions for a business that is being carried on, indicating that the business must be in the operating stage and not merely in the planning or start-up stages.<sup>102</sup> However, the section contributes little else to the definition.

Treasury Regulation Section 1.513-1(b) further defines a trade or business as including any activity carried on for the production of income from the sale of goods or the performance of services. The "production of income" component does not provide a means for distinguishing between types of income-generating activity, such as trades or businesses, investments, or hobbies, all of which can be carried on for the production of income. Further, I.R.C. Section 212(1), which generally authorizes an individual taxpayer to deduct investment expenses, also uses the term production of income.<sup>103</sup> However, the Court has determined that a taxpayer's personal investment activity, no matter how substantial and continuous, is not deemed to be the operation of a trade or business.<sup>104</sup>

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99. Treas. Reg. § 1.513-1(b) (1983).

100. *Id.* Treas. Reg. § 1.513-1(b) was adopted in essentially its current form in 1967. "Proposed regulations were announced in Technical Information Release 899 (Apr. 14, 1967). Final regulations were set out on Dec. 11, 1967, effective for taxable years beginning after Dec. 12, 1967. T.D. 6939, 1968-1 C.B. 274." Sharpe, *supra* note 4, at 415 n.139.

101. See I.R.C. § 162(a) (2000) (providing that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business").

102. *Id.*; *cf. id.* § 174 (permitting deductions for research and development expenses).

103. *Id.* § 212(1) (allowing deductions for expenses paid or incurred for the production or collection of income).

104. See *Comm'r v. Higgins*, 312 U.S. 212, 218 (1941) (finding the taxpayer's personal investment and record-keeping activities insufficient to establish trade or business activity).

Treasury Regulation Section 1.513-1(b) contains the Frankfurter gloss— income from the sale of goods or the performance of services.<sup>105</sup> Treasury Regulation Section 1.513-1(b) was adopted in essentially its current form in 1967.<sup>106</sup> Its definition of trade or business, therefore, predates *Groetzinger*, which rejected the Frankfurter gloss.<sup>107</sup> It is not clear whether the Treasury Department promulgated the definition of a trade or business in the regulation with a specific intent to adopt the Frankfurter gloss as being definitive for purposes of the unrelated business income tax, or whether the Frankfurter gloss was incorporated merely because it was a standard frequently relied on at that time by the courts.

Regulation 1.513-1(b) also provides that a nonprofit organization's activity may be broken down or fragmented into component parts, and the unrelated business income tax be applied to just a component part.<sup>108</sup> Activities of producing goods or performing services do not lose their identity as a trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that may or may not be related to the organization's exempt purpose.<sup>109</sup> In other words, the regulation permits the Internal Revenue Service to fragment an integrated business activity, which might be related to the nonprofit organization's exempt purpose, into component parts in order to treat a component part as an unrelated trade or business.<sup>110</sup> For example, a journal published by an exempt organization might further its exempt purpose, but the advertising contained in the journal may become subject to the unrelated business income tax.<sup>111</sup>

In 1969 Congress enacted I.R.C. Section 513(c),<sup>112</sup> which adopted the regulation's concept of fragmenting a business into its component parts as provided in Regulation 1.513-1(b). Section 513(c) provides as follows:

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105. Treas. Reg. § 1.513-1(b) (1983).

106. See *supra* note 100 (outlining the promulgation of this regulation).

107. See *supra* notes 95–96 and accompanying text (discussing the rejection of the Frankfurter gloss).

108. Treas. Reg. § 1.513-1(b); see also Sharpe, *supra* note 4, at 418 (discussing the Treasury Department's determination to tax advertising income by promulgating this regulation).

109. Treas. Reg. § 1.513-1(b).

110. See *United States v. Am. Coll. of Physicians*, 475 U.S. 834, 839–41 (1986) (discussing the concept of fragmenting a business into its component parts).

111. See Sharpe, *supra* note 4, at 418 (discussing goals of the 1967 regulations).

112. Tax Reform Act of 1969, Pub. L. No. 91-172, § 502(c), 83 Stat. 487, 576 (codified as I.R.C. § 513(c) (2000)).

(c) Advertising, etc., activities.—For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.<sup>113</sup>

At first glance, I.R.C. Section 513(c) appears to provide that, for purposes of the unrelated business income tax, trade or business means the sale of goods or the performance of services; however, it is unclear whether I.R.C. Section 513(c) furnishes an all-inclusive definition of trade or business. Donald Sharpe argues that I.R.C. Section 513(c)'s function is to ensure that a component part of a trade or business as well as a whole business will be included within the unrelated business income tax and, therefore, is not intended to be an all-inclusive definition for purposes of the unrelated business income tax.<sup>114</sup> His position is supported by the House Ways and Means Committee report<sup>115</sup> accompanying H.R. 13270; the report stated in pertinent part as follows:

On December 12, 1967, the Treasury Department promulgated regulations under section 513 of the code concerning the application of the unrelated business tax when the business was a part of a complex of activities which were in the overall carried on in the exercise of the exempt function. These regulations specified that the carrying on of a business in competition with taxpaying business would be subject to tax although the business was only a part of a much larger endeavor related to the exempt function. Thus, unless the business contributed importantly to the exempt purpose or function, the income derived from its operation would be subject to tax.

...

Because of the ensuing controversy over this problem your committee has decided to deal with this subject by legislation. In general, it is in agreement with the purpose of the regulations. Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded

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113. *Id.* § 513(c).

114. See Sharpe, *supra* note 4, at 420 (interpreting the meaning of "includes" in I.R.C. § 513(c), and stating that "the language is presumably not intended as an all-encompassing definition for purposes of a tax on unrelated trade or business"); see also *Am. Coll. of Physicians*, 475 U.S. at 839-40 (observing that by enacting § 513(c), Congress specifically endorsed the Treasury's concept of segregating the trade or business of advertising from the trade or business of publishing an exempt journal).

115. H.R. REP. NO. 91-413 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645.

that by this standard, advertising in a journal published by an exempt organization is not related to the exempt organization's exempt functions, and therefore it believes that this income should be taxed.<sup>116</sup>

In addition, when the 1967 regulations were promulgated, the Internal Revenue Service announced that one of the main effects of the new regulations would be to subject advertising income to the tax.<sup>117</sup>

### *F. Judicial Attempts To Define Unrelated Trade or Business*

The legislative history clearly reflects Congress's concern about unfair competition, diversion of resources, and raising revenue;<sup>118</sup> however, I.R.C. Section 513 does not rely on any of those criteria for determining whether income should be taxed. Instead, the statute looks to whether the nonprofit's activity is related or unrelated to its exempt purpose.<sup>119</sup>

The federal courts struggled to find appropriate criteria when applying the *Higgins* fact test to trade or business determinations in the unrelated business area. Some of the factors that the courts used were whether the nonprofit had a profit motive, whether the business was operated in a competitive commercial manner, or whether there was a risk of unfair competition.<sup>120</sup> The courts

116. *Id.* at 1695.

117. *See Note, supra* note 3, at n.38 (stating that the Internal Revenue Service announced that the new regulations would tax advertising income of exempt organizations and relax restrictions on trade shows) (citing Internal Revenue Service Technical Information Release No. 899 (Apr. 14, 1967), 7 CCH 1967 STAND. FED. TAX REP. ¶ 6557, at 71,594; Announcement 67-18, 1967 INT. REV. BULL. NO. 19, at 43).

118. *See H.R. REP. NO. 81-2319*, at 36 (1950) ("The problem at which the tax on unrelated business is directed here is primarily that of unfair competition."); *S. REP. NO. 81-2375*, at 28 (1950) (stating that the tax on unrelated business income was meant to address the problem of unfair competition); President's Message to Congress, 96 CONG. REC. 769, 771 (1950) (asking that Congress address the problem of unfair competition between tax-exempt and taxed entities).

119. I.R.C. § 513(a) provides as follows:

(a) General rule. The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income . . . ) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption . . . .

I.R.C. § 513(a) (2000).

120. *See, e.g., La. Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982) (looking to the existence of a profit motive for an activity to constitute a trade or business); *Stanton v. Comm'r*, 399 F.2d 326, 329 (5th Cir. 1968) (opining that business activity is a trade or business if it is extensive activity over a substantial period of time during which the taxpayer held himself out as selling goods or services); *Disabled Am. Veterans v. United States*, 650 F.2d

attempted to extract from Treasury Regulation Section 1.513-1(b) appropriate factors to apply, although the regulation's several references to competition created uncertainty among the courts as to what weight, if any, should be accorded to the risk of unfair competition.

In *Clarence LaBelle Post No. 217 v. United States*,<sup>121</sup> the Eighth Circuit held that the existence of unfair competition was not a necessary condition for imposing the unrelated business income tax; the desire for revenue also motivated Congress.<sup>122</sup> The plaintiff, a fraternal and patriotic veterans organization in Minnesota exempt under I.R.C. Section 501(c)(4), sued for refund after the Internal Revenue Service imposed the unrelated business income tax on income the taxpayer received from bingo games.<sup>123</sup> Minnesota only permitted nonprofit organizations to operate bingo games; therefore, the plaintiff did not compete against any commercial enterprise.<sup>124</sup> The plaintiff prevailed in the district court on its argument that an unrelated trade or business could be taxed only if the trade or business competed with a taxpaying entity because the purpose of the tax was to prevent unfair competition.<sup>125</sup> On appeal, the government successfully argued that the tax applied to any unrelated trade or business.<sup>126</sup>

The appellate court noted the legislative history indicated that although Congress was concerned with eliminating unfair competition, "that goal existed only as part of a larger goal of raising revenue."<sup>127</sup> Further, the court noted that the recently enacted I.R.C. Section 513(d) furnished evidence "that sections 511-513 should be interpreted broadly to apply to all businesses falling within the literal meaning of the term 'any trade or business.'"<sup>128</sup> The court also noted that I.R.C. Section 513(d) excluded horse racing at county fairs and the rental of display space at trade shows from the term "unrelated trade or business."<sup>129</sup> The court reasoned that Congress simply could have amended I.R.C. Section 513 to create a general exclusion for any trade or business that did not face competition but instead chose to carve out only two narrow exceptions, thus

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1178, 1187 (Ct. Cl. 1981) (holding that an activity conducted in a competitive, commercial manner is a trade or business):

121. *Clarence LaBelle Post No. 217 v. United States*, 580 F.2d 270 (8th Cir. 1978).

122. *Id.* at 272.

123. *Id.* at 271.

124. *Id.*

125. *Id.*

126. *Id.* at 272.

127. *Id.*

128. *Id.* at 273.

129. *Id.*

indicating that lack of competition was not a sufficient factor to exclude an unrelated trade or business from the tax.<sup>130</sup>

The appellate court also turned for support to Treasury Regulation Section 1.513-1(b). The court interpreted the regulation to focus primarily on the commercial nature of the activity to be taxed, and stated that "references to competition serve merely to explain reasons why an activity that lacks a commercial orientation should not be considered a trade or business."<sup>131</sup>

In contrast, the Seventh Circuit in *Hope School v. United States*<sup>132</sup> found that the existence of unfair competition was the primary consideration for determining if an exempt organization was engaged in an unrelated trade or business, expressly disagreeing with the Eighth Circuit:

To the extent the [*LaBelle*] court held that unfair competition is not the only factor to be considered, we support its holding . . . . However, to the extent that *LaBelle* may hold that unfair competition is not the primary consideration, we disagree.<sup>133</sup>

The Seventh Circuit also rejected profit motive as an appropriate test for determining if an exempt organization's activities rise to the level of a trade or business:

The Internal Revenue Code nowhere gives a precise definition of "trade or business," but some guidelines can be gleaned from the Treasury Regulations and case law. In regulation § 1.513-1(b), the Service states that the same standard applies for determining whether an activity constitutes a trade or business for purposes of section 513 as for purposes of section 162 . . . . In *McDowell v. Ribicoff*, 292 F.2d 174, 178 (3rd Cir.) . . . a case discussing the requirements for a trade or business under section 162, the court elaborated further:

The phrase 'trade or business' connotes something more than an act or course of activity engaged in for profit. Indeed, the Internal Revenue Code itself . . . distinguishes between a 'trade or business' on the one hand and a 'transaction entered into for profit' on the other.<sup>134</sup>

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130. See *id.* (noting that Congress "chose to carve out only two specific exceptions rather than create a general exception for noncompetitive businesses operated by tax-exempt organizations").

131. *Id.* at 274 (internal quotations omitted).

132. *Hope School v. United States*, 612 F.2d 298 (7th Cir. 1980).

133. *Id.* at 304.

134. *Id.* at 301.

Several years later, the Fifth Circuit issued its opinion in *Louisiana Credit Union League v. United States*,<sup>135</sup> endorsing a profit-motive standard for determining the existence of a trade or business:

We believe that the "profit motive" standard is the proper one to be applied in this case, for it is consistent with the plain language of section 513 as well as the accompanying regulations. The statute, which clearly encompasses within its parameters any activity "carried on for the production of income," first raises the issue of motive. The regulations, which invoke section 162 and its "profit motive" gloss, confirm that motive is the key inquiry. Thus, to determine whether a tax-exempt organization is carrying on a trade or business, the court must look to see whether that institution is engaged in extensive activity over a substantial period of time with the intent to earn a profit.<sup>136</sup>

In each one of these cases, the courts were interpreting the same code sections and regulations to devise an appropriate standard for determining the existence of an unrelated trade or business, yet the courts could not even agree about which factors should be relevant (unfair competition, revenue raising, or profit motive).

In 1986, several months before its decision in *Groetzing*, the Supreme Court stepped into the fray and issued its opinion in *United States v. American Bar Endowment*.<sup>137</sup> The American Bar Endowment (ABE) was an I.R.C. Section 501(c)(3) organization that distributed grants to charitable and education groups in order to fulfill its primary purpose of advancing legal research and promoting the administration of justice.<sup>138</sup> ABE obtained the funds for the grants by providing group insurance underwritten by major insurance companies to its members.<sup>139</sup> ABE negotiated the premiums with the insurers, compiled lists of its members, solicited and collected the insurance premiums from them, transmitted the premiums to the insurers, maintained files on the policyholders, and answered members' questions.<sup>140</sup> The insurers' cost of providing the insurance was less than the premium ABE paid, and every year the insurers would refund the excess to ABE as a dividend.<sup>141</sup> As a condition of participating in the insurance program, ABE

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135. See *La. Credit Union League v. United States*, 693 F.2d 525, 543 (5th Cir. 1982) (finding that the Internal Revenue Service correctly assessed a tax on a nonprofit entity for unrelated business income).

136. *Id.* at 532.

137. *United States v. Am. Bar Endowment*, 477 U.S. 105 (1986).

138. *Id.* at 107.

139. *Id.*

140. *Id.*

141. *Id.* at 108.



members had to agree to allow ABE to keep the dividend rather than distribute it pro rata to the participating members.<sup>142</sup> Therefore, ABE could have negotiated a lower premium for its members, but instead priced the policies competitively with other insurance policies available to the public.<sup>143</sup>

The Claims Court found that ABE was not engaged in a trade or business,<sup>144</sup> and the Court of Appeals for the Federal Circuit affirmed.<sup>145</sup> The Supreme Court reversed, stating that "ABE's activity is both 'the sale of goods' and 'the performance of services,' and possesses the general characteristics of a trade or business."<sup>146</sup> Although *American Bar Endowment* was supposed to provide some clarity as to what constitutes a trade or business in the nonprofit area, it did not do so. The Supreme Court relied in part on the Frankfurter gloss contained in Treasury Regulation Section 1.513-1(b). Just months after its decision in *American Bar Endowment*, the Supreme Court decided *Groetzinger*<sup>147</sup> and rejected the Frankfurter gloss, stating:

We are not satisfied that the Frankfurter gloss would add any helpful dimension to the resolution of cases such as this one, or that it provides a "sensible test," as the Commissioner urges. . . . It might assist now and then, when the answer is obvious and positive, but it surely is capable of breeding litigation over the meaning of "goods," the meaning of "services," or the meaning of "holding one's self out." And we suspect that—apart from gambling—almost every activity would satisfy the gloss. A test that everyone passes is not a test at all. We therefore now formally reject the Frankfurter gloss which the Court has never adopted anyway.<sup>148</sup>

Therefore, it is unclear how much vitality the sale of goods or performance of services language in the regulation remains.

The Supreme Court in *American Bar Endowment* also relied on I.R.C. Section 513(c)'s definition of a trade or business as "any activity which is carried on for the production of income from the sale of goods or the performance of services."<sup>149</sup> However, it is unclear whether I.R.C. Section

142. *Id.*

143. *Id.*

144. *See Am. Bar Endowment v. United States*, 4 Cl. Ct. 404, 411–12 (1984) (holding that ABE's activities did not meet the statutory requirements of a trade or business and were thus untaxable).

145. *See Am. Bar Endowment v. United States*, 761 F.2d 1573, 1574 (Fed. Cir. 1985) (upholding the Claims Court's finding that the Internal Revenue Service could not assess a tax on ABE).

146. *United States v. Am. Bar Endowment*, 477 U.S. 105, 110–11 (1986).

147. *Comm'r v. Groetzinger*, 480 U.S. 23 (1986).

148. *Id.* at 34.

149. *Am. Bar Endowment*, 477 U.S. at 110.

513's definition is intended to be an all-inclusive definition of a trade or business for purposes of the unrelated business income tax, or whether it is confined to situations where a trade or business is broken down into component parts.<sup>150</sup>

Even if the Supreme Court intended sale of goods and performances to be the definitive standard, the Court muddied the waters by giving seeming credence to the Claims Court's position that an activity is a trade or business if it is operated in a "competitive, commercial manner."<sup>151</sup> The Claims Court had then concluded that, in fact, ABE did not operate its insurance activity as a trade or business.<sup>152</sup> The Supreme Court rejected the Claims Court's position, but on the merits, that is, the Supreme Court rejected the Claims Court's conclusions but not its application of the standard.<sup>153</sup>

The Claims Court also found that ABE's activities were not a trade or business because they did not present the potential for unfair competition.<sup>154</sup> Again, the Supreme Court did not reject the Claims Court's application of the standard but rather the conclusions that the Claims Court drew from applying the standard.<sup>155</sup> As a result, it remains unclear which standard should be applied in determining whether a nonprofit organization is engaging in a trade or business, or whether, in fact, all of these standards may be applied. Against this backdrop, the courts then were forced to turn their attention to determining when an activity is a royalty exempt from the unrelated business income tax under I.R.C. Section 512(b).

### *III. Interpretation of the Royalty Exception*

#### *A. Mailing List Rentals*

The first cases that raised challenges to the extent of the royalty exception to the unrelated business income tax involved mailing lists rentals. Disabled

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150. See *supra* note 114 and accompanying text (discussing Professor Sharpe's position as to the intended meaning of § 513(c)).

151. See *Am. Bar Endowment*, 477 U.S. at 111 (citing the Claims Court opinion).

152. See *Am. Bar Endowment v. United States*, 4 Cl. Ct. 404, 409 (1984) (deciding that ABE did not operate a trade or business for the purposes of the tax assessment).

153. See *Am. Bar Endowment*, 477 U.S. at 111-14 (concluding that the Claims Court misconstrued the facts of the case and thus reached the incorrect outcome on the merits).

154. See *Am. Bar Endowment*, 4 Cl. Ct. at 413-14 (focusing on the competitive aspects of the activities).

155. See *Am. Bar Endowment*, 477 U.S. at 114-15 (concluding that the court misapplied the law to the facts).

American Veterans (DAV) brought suit for refund of more than \$4 million in taxes paid from 1970 through 1973 on income from the rental of its mailing list.<sup>156</sup> DAV was an I.R.C. Section 501(c)(4) organization that World War I veterans formed in 1920 for the primary purpose of providing disabled veterans with assistance at benefit hearings before the Veterans Administration boards.<sup>157</sup> DAV obtained the funds for its operation primarily by soliciting donations, and to that end, it maintained a mailing list that at times contained more than 11 million names, along with such information as the original source of the name and the amount of the contribution.<sup>158</sup> DAV "expended considerable time, effort and expense" to maintain the list and deleted obsolete names and added new ones every six months.<sup>159</sup> In order to obtain additional revenues and to help defray some of the expense of maintaining the list, DAV began renting its list to both tax-exempt and commercial organizations, following the usual trade practices of the direct mail industry.<sup>160</sup>

As is standard in the mailing list rental industry, DAV prepared "rate cards" that specify the rate for rentals (for example, \$45 per 1000), additional charges for services such as sorting the list by zip code or size of donation, and the charges for the type of medium used to transmit the list (for example, gummed or preprinted labels, or magnetic tape).<sup>161</sup> The Tax Court in *Disabled American Veterans v. Commissioner*<sup>162</sup> (DAV II) made additional findings as to how DAV conducted its mailing list rental activities. DAV did not use the services of a third party to fill the rental orders but instead directly provided the list renter with the names, either on computer disk or on a variety of preprinted labels, for which DAV charged extra.<sup>163</sup> DAV devoted two man-years to the rental activity each year and did not use volunteers or unpaid workers.<sup>164</sup> Sometimes, the rate cards were sent to list brokers to find potential list users.<sup>165</sup> The list broker would work on a commission basis—the broker would receive a certain percentage of the rental price—and DAV would bill the list broker

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156. *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1180 (Cl. Ct. 1981) (citing to the trial judge's opinion).

157. *See id.* at 1182 (explaining the background of DAV).

158. *See id.* (stating facts).

159. *Id.*

160. *See id.* at 1184 (explaining the rental practice).

161. *Id.* at 1184–85.

162. *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60 (1990).

163. *See id.* at 65 (explaining the medium of delivery); *see also* *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1184–85 (Cl. Ct. 1981) (same).

164. *Disabled Am. Veterans*, 94 T.C. at 66.

165. *See Disabled Am. Veterans*, 650 F.2d at 1184 (explaining the use of list brokers).

directly.<sup>166</sup> As is standard in the industry, DAV reserved the right to examine the materials mailed by the list renter.<sup>167</sup>

The court concluded that DAV's rental of its mailing list was a trade or business, holding that if an activity is conducted in a competitive, commercial manner, it is a trade or business for purposes of the unrelated business income tax.<sup>168</sup> The court found that there was an active direct mail industry with its own set of trade practices and that DAV was a participant in the industry. DAV set its mailing list rentals at competitive rates, charging higher rates to organizations for which the list had greater value and charging additional fees for additional services, such as sorting by zip code.<sup>169</sup>

The court gave short shrift to DAV's assertion that its mailing list rental income was exempt as a royalty, dismissing the argument at the end of the opinion as follows:

[S]ection 512(b) excludes from taxation the conventional type of passive investment income traditionally earned by exempt organizations (dividends, interest, annuities, real property rents). . . . DAV's list rentals are the product of extensive business activity by DAV and do not fit within the types of "passive" income set forth in section 512(b). The "royalties" there referenced are those which constitute passive income, such as the compensation paid by a licensee to the licensor for the use of the licensor's patented invention, . . . or the share of production reserved to the owner of property for permitting another to work mines and quarries or drill for oil or gas . . . .<sup>170</sup>

In rendering its decision that DAV engaged in a trade or business, the Court of Claims focused not only on the extent of DAV's activities but on the fact that DAV charged competitive rental rates for the mailing list.<sup>171</sup> However, that factor would not distinguish between a trade or business and an investment. An investor would want to receive a competitive rate of return on a dividend or interest payment. Profit motive underlies both the operation of a trade or business and investment activities and distinguishes hobbies from trades and businesses or investments. Profit motive does not transform investment activity into a trade or business.

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166. See *Disabled Am. Veterans*, 94 T.C. at 65 (explaining the list broker process).

167. See *Disabled Am. Veterans*, 650 F.2d at 1185 n.14 (explaining the right to examine).

168. See *id.* at 1187 (setting forth the standard for determining whether a particular activity is a trade or business). The court also held that the unrelated business income tax is not restricted to those situations where unfair competition has been established. *Id.*

169. See *id.* at 1187–88 (pointing out DAV's activities that subjected it to the unrelated business tax).

170. *Id.* at 1189.

171. See *id.* at 1187 (highlighting the competitive aspects of the rates).

In response to the Court of Claims' decision, Congress enacted I.R.C. Section 513(h) in 1986,<sup>172</sup> which provides that an unrelated business or trade does not include the rental or exchange of mailing lists between I.R.C. Section 501 organizations to which contributions are deductible under I.R.C. Section 170.<sup>173</sup> The legislative history makes it clear that no inference was to be drawn as to whether revenues derived from rentals or exchanges between organizations other than those stated above are unrelated business income.<sup>174</sup>

Shortly after the Court of Claims' decision in *DAVI*, the Internal Revenue Service issued Revenue Ruling 81-178 setting forth two situations to demonstrate when unrelated business income is taxable.<sup>175</sup> Both situations involve a tax-exempt organization of professional athletes. In the first, the organization solicits and negotiates with a commercial enterprise for the licensing of the organization's trademark and tradename, and athletes' names, photographs, likenesses, and facsimile signatures in connection with the business's sale of merchandise and services.<sup>176</sup> The organization retains the right to approve the quality and style of the products and services that will display the licensed items.<sup>177</sup> In the second situation, the athletes are required to make personal appearances and give interviews in connection with the business's sale of its products and services.<sup>178</sup>

The Internal Revenue Service's position was that the income in both instances was unrelated business income; however, the income in the first situation was exempt as royalty income. The income in the second situation was taxable because the exempt organization was obligated to perform personal services for the commercial enterprise.<sup>179</sup> Significantly, the Internal Revenue Service defined royalty income as arising from the use of a valuable intangible property right.<sup>180</sup> The Revenue Ruling does not make mention of "passive" income from "conventional" investment type sources such as dividends or interest.<sup>181</sup> It is also significant that the tax-exempt organization was permitted

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172. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1601, 100 Stat. 2085, 2766-67.

173. *Id.*

174. H.R. CONF. REP. NO. 99-841 (1986); STAFF OF THE JOINT COMMITTEE ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1325 (Comm. Print 1987).

175. Rev. Rul. 81-178, 1981-2 C.B. 135 (1981).

176. *Id.*

177. *Id.*

178. *Id.* at 136.

179. *Id.* at 137.

180. *Id.* at 136.

181. *Id.* at 135-37.

to solicit and to negotiate the contracts and retained the right to review the associates' products and services without jeopardizing the classification of the income as royalty.<sup>182</sup> The Internal Revenue Service apparently recognized that the tax-exempt organization must perform some activities or services in order to exploit its intangible property. This seems inconsistent with the Internal Revenue Service's position in *DAV I* and *DAV II*, discussed below, when the Internal Revenue Service argued that the tax-exempt organization's business activity with regard to the licensing of the intangible property right—the mailing list—meant that the income was not "passive" in nature and, therefore, not royalty income.

DAV then resisted the Internal Revenue Service's attempts to assess a tax on the mailing list income for the 1974–1983 tax years, and filed suit in the Tax Court.<sup>183</sup> DAV argued that it was not collaterally estopped from litigating its tax liability because Revenue Ruling 81-178 was a significant legal development that allowed the court to reconsider the taxability of mailing list rental income.<sup>184</sup>

The Tax Court found virtually the same facts as the Court of Claims regarding DAV's maintenance and rental activities; however, the Tax Court decided that the rental income was exempt under I.R.C. Section 512(b).<sup>185</sup> The court determined that DAV's principal purpose underlying its list maintenance activities was to assist DAV with its own fundraising efforts.<sup>186</sup> Segmenting the list by zip code, for example, enabled DAV to take advantage of bulk mailing rates; segmenting the list by amount of contribution allowed DAV to target certain donors with specialized appeals for contributions.<sup>187</sup> By taking such measures as segmenting and regularly updating the list, DAV reduced its fundraising costs and satisfied the standards set by the Council of Better Business Bureaus and the National Charities Information Bureau.<sup>188</sup>

The Internal Revenue Service argued that all this activity—maintaining and providing rate cards, using employees for the rental activities, organizing the list into segments, reviewing any solicitation material sent to donors by renters, and regularly renting the list—indicated that the rental income was not royalty income.<sup>189</sup> The Internal Revenue Service reasoned that royalties must

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182. *Id.* at 135.

183. *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60 (1990).

184. *Id.* at 69.

185. *Id.* at 72.

186. *Id.* at 78.

187. *Id.* at 63.

188. *Id.*

189. *Id.* at 73.

be "passive," and these rental payments were not passive because of all the activity in which DAV engaged; therefore, the payments were not royalties.<sup>190</sup>

The court held that the Internal Revenue Service was confusing the factors that would determine if an activity is a trade or business with whether the income is a royalty.<sup>191</sup> "A taxpayer may license an intangible asset and expend a great deal of effort to make the intangible asset valuable, but the payments received for the use of the intangible asset are nevertheless characterized as royalties."<sup>192</sup> Taking steps to preserve or to increase an asset's value would not transform a payment from being a royalty into something else. The list continues to be intangible personal property.<sup>193</sup> Many of DAV's actions that the Internal Revenue Service argued made the list appealing to renters were undertaken for the primary purpose of maintaining a productive fundraising list for its own purposes.<sup>194</sup> The benefit to renters was incidental.<sup>195</sup>

Further, the Tax Court rejected the Court of Claims' contention in *DAVI* that I.R.C. Section 512(b) only excluded royalty income from "passive" sources, and noted that "Congress has distinguished between passive royalties and those derived from the active conduct of a business in other statutory language of the Code but not in [I.R.C.] [S]ection 512(b)(2)."<sup>196</sup> The Court of Appeals for the Sixth Circuit reversed the Tax Court on the ground that the Court of Claims' decision collaterally estopped DAV from litigating in the Tax Court whether mailing list income was exempt from taxation.<sup>197</sup>

The Tax Court subsequently had the opportunity to decide the royalty exemption issue in *Sierra Club, Inc. v. Commissioner*<sup>198</sup> (*Sierra Club I*). *Sierra Club* was a Section 501(c)(4) organization that derived substantial income from 1985 through 1987 from the rental of mailing lists and the licensing of its name and logo on affinity cards.<sup>199</sup> *Sierra Club I* is the Tax Court's decision rendering summary judgment on the issue of the mailing lists.<sup>200</sup> *Sierra Club*

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190. *Id.* at 71.

191. *Id.* at 73-74.

192. *Id.* at 74.

193. *Id.* at 72.

194. *Id.* at 78.

195. *Id.*

196. *Id.* at 75.

197. *See generally* *Disabled Am. Veterans v. Comm'r*, 942 F.2d 309 (6th Cir. 1991).

198. *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582 (1993).

199. *Id.* at 2583-84.

200. *Id.* at 2592.

*II*,<sup>201</sup> which will be discussed later, is the Tax Court's summary judgment decision on the affinity card issue.<sup>202</sup>

Sierra Club operated its mailing list rental business in a manner very similar to the situations in *DAV I* and *DAV II*, with one very important distinction: Sierra Club did not use its own employees to maintain or market the mailing list or to fill and bill for rental orders. Instead, Sierra Club employed a list manager and list broker to market its mailing lists and employed an independent computer service to fill the requests, although Sierra Club retained the right to review requests or any materials renters would be mailing and to approve the mailing schedule.<sup>203</sup> In *DAV I* and *DAV II* the parties and the courts scrutinized Disabled American Veterans' activities to determine if they were the operation of a trade or business or the exploitation of a valuable, intangible property interest. In *Sierra Club I*, the exempt organization itself was not performing most of the activities;<sup>204</sup> therefore, the Internal Revenue Service shifted its focus to the nature of the property interest, arguing that "in using the term 'royalties' in I.R.C. Section 512(b)(2), Congress had in mind only 'investment income', and intended the term 'royalties' in that section to describe only income of that character."<sup>205</sup>

The Tax Court accepted *DAV II*'s definition of "royalties" as payments for the use of valuable, intangible property rights<sup>206</sup> and continued to disagree with the Court of Claims that I.R.C. Section 512(b)(2) refers only to royalties from "passive" sources.<sup>207</sup> Instead, the Tax Court continued to maintain the position it had taken in *DAV II* "that Congress did not intend to exclude from I.R.C. Section 512(b)(2), royalties derived from carrying on a trade or business."<sup>208</sup>

The Internal Revenue Service ostensibly abandoned its earlier argument that Congress intended to draw a distinction between "passive" and "active" income,<sup>209</sup> but instead argued that Congress intended to exclude only "investment" income by citing the legislative history in support of its

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201. *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307 (1994).

202. *Id.* at 344.

203. *Sierra Club, Inc.*, 65 T.C.M. at 2585-86.

204. *Id.* at 2583.

205. *Id.* at 2586.

206. *Id.* at 2587.

207. *Id.* at 2586. Interestingly, the Tax Court did not cite or rely on Revenue Ruling 81-178 either to support its position that a royalty is defined as a valuable property right or to rebut the Internal Revenue Service's position that royalty income must be passive to be exempt. *Id.* at 2587.

208. *Id.* at 2585.

209. *Id.* at 2586.



position.<sup>210</sup> Specifically, the Internal Revenue Service referred to the Senate Finance Committee report discussing the proposed enactment of what would become I.R.C. Sections 512 and 513 where it was stated in pertinent part:

Dividends, interest, royalties, most rents, capital gains and losses, and similar item are excluded from the base of the tax on unrelated income because your committee believes that they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, *investment-producing incomes of these types* have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.<sup>211</sup>

The Tax Court dismissed the Internal Revenue Service's position not only as a restatement of the passive-active argument already rejected by the court and abandoned by the Internal Revenue Service in Revenue Ruling 81-178, but also as not supported by the legislative history.<sup>212</sup> The Tax Court reviewed the House Ways and Means Committee report<sup>213</sup> and other language contained in the Senate Finance Committee report,<sup>214</sup> and noted that the legislative history could be interpreted as merely stating that investments producing incomes such as dividends, interest, and royalties are proper for educational and charitable organizations.<sup>215</sup> Further, both reports stated that income other than investment income was within the purview of the exception to unrelated business income contained in I.R.C. Section 513(b)(2):

All dividends, interest, annuities, and royalties . . . are excluded from the concept of unrelated business net income. This exception applies not only to investment income, but also to such items as business interest on overdue open accounts receivables.<sup>216</sup>

On appeal, the Ninth Circuit<sup>217</sup> determined that the dispute centered on the issue of the proper definition of a royalty.<sup>218</sup> After reviewing both Webster's Ninth New Collegiate and Black's Law Dictionaries, the court determined that a "royalty" is "a payment made to the owner of property for

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210. *Id.*

211. *Id.* at 2587 (quoting S. REP. NO. 81-2375, at 506 (1950)) (emphasis added by court).

212. *Id.* at 2587.

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* (quoting S. REP. NO. 81-2375, at 560 (1950); H.R. REP. NO. 81-2139 (1950)).

217. *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526 (9th Cir. 1996).

218. *Id.* at 1530.

permitting another to use the property."<sup>219</sup> The Internal Revenue Service argued that the definition needed to be refined further to include only royalties that are "passive" in nature.<sup>220</sup> After reviewing prior decisions such as *DAVI* and Revenue Ruling 81-178, the appellate court determined that royalties must be passive in nature in the sense that they do not include payment for services.<sup>221</sup> Because Sierra Club did not perform the list maintenance and marketing services directly but used independent third parties, the court held that the income from the mailing list rentals was royalty and, therefore, exempt.<sup>222</sup> Thus, the court laid the groundwork for continued argument over the amount of activity an exempt organization can perform with regard to royalty income before it no longer would be deemed "passive."<sup>223</sup> The court rejected the Internal Revenue Service's contention that an exempt organization could perform *no* services,<sup>224</sup> yet it did not indicate the nature and frequency of the services that an exempt organization could perform before jeopardizing the status of the income.

### B. Affinity Card Licensing Agreements

The Tax Court also rendered summary judgment for Sierra Club on the affinity card issue (*Sierra Club II*).<sup>225</sup> In *Sierra Club I*, the Internal Revenue Service conceded that the income from the mailing list rentals could be considered royalties but not the kind of royalties that Congress intended to exempt from the unrelated business income tax. In *Sierra Club II*, the Internal Revenue Service argued that the income from the affinity cards was not royalty income at all, but rather profits from either a joint venture or sole proprietorship.

An affinity card program works as follows: An exempt organization, such as Sierra Club or a university, enters into an agreement with a financial institution permitting it to use the exempt organization's name and logo on credit cards issued by the financial institution. These cards are marketed to the

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219. *Id.* at 1531.

220. *Id.* at 1532.

221. *Id.*

222. *Id.* at 1536.

223. See generally Jennifer Anne Spiegel, Note, *Sierra Club: Rationalizing the Royalty Exception to the Unrelated Business Income Tax*, 63 *FORDHAM L. REV.* 1697 (1995).

224. *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1535 (9th Cir. 1996).

225. See *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307, 344 (1994) (finding no issue of material fact as to whether the income received by Sierra Club was considered royalties under I.R.C. § 512(b)(2)).

exempt organization's members, usually by using the mailing list. The financial institution pays the exempt organization a fee based on a certain percent of the total purchases made by the consumer. Sometimes the exempt organization uses the services of a third party to find an appropriate financial institution and to solicit the members to sign up for the card. In that case, the financial institution usually pays the third party a fee, and the third party in turn gives the exempt organization a portion of the fee.

Sierra Club entered into a typical affinity card agreement with a third party and a bank. Sierra Club did not pay tax on the monies earned from the arrangement, reasoning that they were exempt as royalties. The Internal Revenue Service argued that the monies received were taxable on the ground that Sierra Club and the other parties entered into a joint venture because they "agreed to share . . . the revenues . . . received from merchants when individual holders of [Sierra Club] credit cards made purchases."<sup>226</sup> The Tax Court examined the factors used to determine the existence of a joint venture, including mutual control over and responsibility for the venture, and the most significant factor, a mutual proprietary interest in the net profits.<sup>227</sup>

When the consumer makes a purchase with the card, the financial institution is liable to the vendor for payment. Because the vendor's risk of loss from an uncollectible account is minimal and the vendor is assured of prompt payment, vendors give the financial institution a discount, typically three percent. However, the financial institution incurs some costs, such as overhead and the risk of uncollectible accounts. The financial institution will have a net profit if these costs do not exceed the three-percent discount.<sup>228</sup>

The Tax Court determined that Sierra Club did not have a proprietary interest in the net profits; Sierra Club was entitled only to contingent compensation based on total cardholder sales.<sup>229</sup> Although the agreements

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226. *Id.* at 320.

227. *Id.* at 323; *see also id.* at 324 (stating "that the 'central feature' of a joint venture is 'a proprietary interest in the net profits of the enterprise coupled with an obligation to share its losses'" (quoting *Federal Bulk Carriers, Inc. v. Comm'r*, 66 T.C. 283, 293 (1976), *aff'd.*, 558 F.2d 128 (2d Cir. 1977))).

228. The financial institution also earns a profit on the consumer's credit card purchases if the consumer pays the financial institution interest. If the consumer pays in full the balance on the credit card by the payment due date, the consumer will not be charged interest by the financial institution on the purchases made. If the bill is not paid in full, however, the consumer accesses the "credit reserve" and pays the financial institution interest on the balance. Again, the financial institution will earn a net profit if its costs are less than the interest the consumer pays.

229. *See Sierra Club, Inc. v. Comm'r*, 103 T.C. 307, 327-28 (1994) (stating that the books and records were inconsistent with the Internal Revenue Service's determination of a joint venture).

provided for some adjustment in the percentage that the Sierra Club would receive, Sierra Club was insulated from risk of loss.<sup>230</sup> If the bank's cost of funds increased, the vendor discount decreased, or if cardholders failed to pay their accounts, Sierra Club continued to receive a certain percentage.<sup>231</sup> Conversely, if the bank was able to increase its profits by negotiating a higher vendor discount or decreasing its costs, Sierra Club did not share in the increase.<sup>232</sup> Sierra Club did not share in the risks or the rewards of the credit card program.

The Tax Court also found it significant that the parties had discrete, not mutual, responsibilities.<sup>233</sup> Sierra Club retained control over its name and logo; the third party promoter was responsible for soliciting and marketing; and the bank had complete discretion whether to accept an application for a card.<sup>234</sup> The provision in the various agreements that the parties would cooperate with each other did not amount to mutual control.<sup>235</sup>

#### *IV. The Neglected Analogy Between Mailing List Rental and Affinity Card Arrangement and Overriding Royalties*

##### *A. Legislative History Does Not Distinguish Between Types of Royalties*

When Congress first enacted the unrelated business income tax provisions in 1950, it believed that an exempt organization could earn certain types of income without posing a danger to competition. The reports of the Senate

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230. See *id.* at 333–34 (considering factors to determine whether Sierra Club was in the business of selling financial services).

231. See *id.* at 325 (finding that Sierra Club did not "bear a share of either (1) . . . [the] cost of funds, (2) losses on account of uncollectible accounts, or (3) any direct or overhead costs").

232. See *id.* at 326 (discussing Sierra Club's rewards and obligations under the agreement).

233. See *id.* at 329 (finding no delegation of authority to manage the affinity card program evidencing a partnership).

234. See *id.* at 312, 319 (setting forth some terms of the agreement).

235. *Id.* at 329. The Tax Court also rejected the Internal Revenue Service's sole proprietorship argument. The Internal Revenue Service argued that Sierra Club was engaged in the business of marketing credit cards, with the promoter acting as the Sierra Club's agent. Therefore, the Sierra Club was using its name and logo in its own business which does not give rise to royalty income. The Tax Court found that the Sierra Club did not have sufficient control of the promoter's actions to render it the Sierra Club's agent. Therefore, the promoter's actions could not be imputed to Sierra Club to put it in the business of selling credit cards. The promoter had proposed the arrangement to Sierra Club, not vice versa. In addition, Sierra Club dealt with the promoter at arms' length on such matters as the promoter advertising the availability of the credit cards for a standard fee in Sierra Club's magazine.

Finance Committee and the House Ways and Means Committee<sup>236</sup> reflect Congress's belief that certain classes of income could be excluded from the unrelated business income tax safely without jeopardizing competition. The House report stated in pertinent part:

[T]he tax applied to unrelated business income does not apply to dividends, interest, royalties . . . , rents . . . , and gains from the sales of leased property. Your committee believes that such "passive" income should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for education and charitable purposes.<sup>237</sup>

Likewise, the Senate Finance Committee's report stated that "dividends, interest, royalties, most rents, and capital gains and losses and similar items . . . are 'passive' in character."<sup>238</sup> The committees' use of the word "passive" has bedeviled courts and commentators ever since. The legislative reports did not define "passive income" or "royalty," nor did Congress include the word "passive" with regard to the Section 512(b) royalty exclusion from income.<sup>239</sup> This is particularly significant because Congress has made distinctions with regard to royalties derived from the active conduct of a trade or business in other sections of the Code.<sup>240</sup>

The Internal Revenue Service has made two slightly different arguments when arguing that royalty income from mailing lists and affinity cards is taxable: (1) if the income is not derived from conventional investments, then the income is not a royalty;<sup>241</sup> or (2) royalty income may be derived from conventional investments, or from the conduct of a trade or business, but Congress only intended to exempt the former kind.<sup>242</sup> In making either

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236. S. REP. NO. 81-2375 (1950); H.R. REP. NO. 81-2319 (1950).

237. H.R. REP. NO. 81-2319, at 38 (1950).

238. See S. REP. NO. 81-2375, at 30 (1950) (noting that those items are excluded from the base of the tax on unrelated income).

239. See I.R.C. § 512(b) (2000) (setting forth the modifications of subsection (a)).

240. See, e.g., *id.* § 954(c)(2) (providing in part that "[f]oreign personal holding company income shall not include rents and royalties which are derived in the active conduct of a trade or business"); *id.* § 543(a)(1)(C) (providing in part that "[t]his paragraph shall not apply to . . . active business computer software royalties").

241. See *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1189 (1981) (finding that the defendant's list rental income was not "passive" and was therefore not considered a royalty); *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 71 (1990) (setting forth the Internal Revenue Service's argument that because the petitioner's income was an active business, it was not a royalty).

242. See *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582, 2586 (1993) (setting forth the Internal Revenue Service's argument that Congress intended only "investment income" to be considered "royalties").

argument, the Internal Revenue Service and some of the courts have engrafted a "passivity" requirement onto the statutory exceptions and have cited the above legislative history as evidence of congressional intent.

The Internal Revenue Service and the courts have read too much meaning into the legislative history's use of the word "passive." The legislative history clearly reflects congressional dissatisfaction with exempt organizations operating going concerns such as manufacturing enterprises or retail stores that were indistinguishable from businesses operated by commercial entities.<sup>243</sup> Congress equally was concerned with not sweeping into the unrelated business income tax income derived from sources that Congress believed did not pose threats to competition.<sup>244</sup> Some of the testimony from the congressional hearings<sup>245</sup> reflects Congress's struggle to differentiate between an entrepreneurial concern such as the C.F. Mueller Co. and other business activity. Congress employed the terms "active" and "passive" in an attempt to differentiate between an exempt organization's operation of a going concern competing in the commercial sector, which should be taxed, and other business activities, such as, but not exclusively, investments, which should not be taxed. However, the record does not support the argument that Congress intended the word "passive" to have some special or technical meaning that discriminated between types of exempt income.

Vance Kirby, Tax Legislative Counsel with the Treasury Department, in his testimony during the congressional hearings, attempted to draw a distinction between the targeted activities and activities that would remain exempt:

Some of the organizations now exempt from the corporate income tax under section 101 of the Internal Revenue Code, such as charitable and educational institutions and social clubs, were granted exemption because Congress desired to encourage their particular altruistic or group-interest activities, which generally were not conducted for profit. However, nowhere does it appear that Congress contemplated that such organizations would engage in the active conduct of a business.

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The practice has spread in recent years, particularly among charitable and educational institutions, and a wide variety of business activities have been engaged in by such organizations. Thus it is found that these exempt organizations engage in the manufacture of automobile accessories, ceramics, food products, leather goods, and chinaware.

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243. See generally S. REP. NO. 81-2375 (1950); H.R. REP. NO. 81-2319 (1950).

244. See generally S. REP. NO. 81-2375 (1950); H.R. REP. NO. 81-2319 (1950).

245. *Hearings Before House Comm.*, *supra* note 8.

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It is therefore recommended that the unrelated business activities of charitable and educational organizations, business leagues, labor unions, and social clubs be subject to tax at the ordinary corporate rate. A similar proposal was presented to the committee in 1942; since that time the abuse has spread.

...

Under the proposal, the traditional sources of income of these institutions, consisting of interest, dividends, rents, royalties, or capital gains would remain exempt.<sup>246</sup>

Representative Hale Boggs (D-Louisiana) made the prescient observation that the tax on unrelated business income could be interpreted as including all business income and sought assurance from Thomas J. Lynch, General Counsel to the Treasury Department, that such would not occur:

Mr. Boggs: I am simply trying to get information and I am genuinely concerned, because it seems to me that if you can start off with unrelated business activities, that the logical extension is to say that revenue derived from owning real estate or stocks and bonds is also an unrelated business.

Mr. Thomas Lynch: I would not agree to that. We would have it specifically provided as to investment income, rent, and royalties, there is no question whatsoever.<sup>247</sup>

Representatives Walter A. Lynch (D-New York) and J.M. Combs (D-Texas) also questioned Thomas Lynch as to the focus and breadth of the unrelated business income tax:

Mr. Walter Lynch: The only point that is involved here, as I see it, from your recommendation, is whether or not an established business, which, say, has been in competition with other established businesses, has been taken over by an educational institution and operated by the educational institution, should in their competitive business have a 38 percent advantage over other people in the same line of business.

Mr. Thomas Lynch: That is entirely the genesis of the proposal.

...

Mr. Combs: Take this situation in my State: The State University and Texas Agricultural and Mechanical share in it, on a very large body of land;

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246. *Id.* at 165.

247. *Id.* at 176.

part of the permanent endowment; a good deal of that is oil leased and some in oil production. . . . Would the royalties received or proceeds from the operations of these oil properties be affected by the tax change you are proposing?

Mr. Thomas Lynch: They would not be affected by our proposal. Our proposal excludes investment income, which would be returns on ownership of securities, rents, royalties.

Mr. Combs: It would only pertain to business ventures and operations?

Mr. Thomas Lynch: Correct.<sup>248</sup>

The hearings do not support the inference that Congress was attempting to differentiate or had even thought about any potential differences within the category of tax-exempt income items. In other words, Congress used the term "passive" to differentiate between two broad categories of business activity (entrepreneurial-type going concerns and investment-type business activity), but not to differentiate between types of income within one of the two categories.

### *B. Are Royalties Derived from a Trade or Business?*

The Tax Court's analysis in *Sierra Club I* contains the implicit assumption that royalty income is income from a trade or business, but that I.R.C. Section 512(b) exempts that income from taxation.<sup>249</sup> The Tax Court supported its position by examining the structure and interaction of I.R.C. Sections 512(a) and (b).<sup>250</sup> I.R.C. Section 512(a) includes all items of income from an *unrelated* trade or business, regardless of the item's nature (for example, profits, interest, or royalties).<sup>251</sup> However, I.R.C. Section 512(a) does not also include royalties from a *related* trade or business.<sup>252</sup> The focus of Section 512(a) is on unrelated, as opposed to related, trade or business income.<sup>253</sup>

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248. *Id.* at 176–77.

249. *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582, 2583 (1993) (noting that § 512(b)(2) excludes royalties from tax imposed on UBTI).

250. *See id.* at 2585 (stating that this court previously "made it clear that Congress did not intend to exclude from Section 512(b)(2) royalties derived from carrying on a trade or business").

251. *See* I.R.C. § 512(a)(1) (2000) (defining "unrelated business taxable income" for purposes of the subsection).

252. *See id.* (including only royalties for unrelated income).

253. *See id.* (setting forth definitions in relation to "unrelated business taxable income").



I.R.C. Section 512(a) does not sweep into the unrelated business income tax all business income, but only income from an unrelated trade or business. I.R.C. Section 512(b) then modifies I.R.C. Section 512(a) by excluding from its reach certain items of unrelated trade or business income, such as royalties.<sup>254</sup> Therefore, the Tax Court reasoned, if the royalties did not arise from (1) a trade or business (2) that is unrelated, they would not need to be excluded from I.R.C. Section 512(a) by means of I.R.C. Section 512(b).<sup>255</sup> In other words, the royalties must be derived from an unrelated trade or business or they would not need to be excluded from the unrelated business income tax by I.R.C. Section 512(b).

However, the Tax Court might be reading too much into the interplay of I.R.C. Sections 512(a) and 512(b)(2). It is clear from the legislative history that Congress did not want certain types of income to be subject to the unrelated business income tax.<sup>256</sup> Its decision to provide in I.R.C. Section 512(b) that certain kinds of income will not be subject to the unrelated business income tax does not necessarily mean that Congress had concluded that those items of income were derived from a trade or business, whether related or unrelated. Congress's intention simply was to ensure that those items were not taxed; Congress could do so without necessarily having to decide whether in fact the items would have been subject to the tax. Congress has done this in other sections of the Code. For example, I.R.C. Section 62(a)(4) provides that expenses associated with the production of rental or royalty income may be deducted from gross income<sup>257</sup> as opposed to less favorable treatment as

254. See *id.* § 512(b) (excluding certain items from taxation).

255. See *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582, 2587 (1993) (concluding that this was the intent of Congress). However, it is interesting to note that § 512(b) excludes interest and dividends, yet no one argues that interest and dividends are derived from the operation of a trade or business but rather are considered investment income. In other words, § 512(b) excludes items of income that are not trade or business income.

256. S. REP. NO. 81-2375 (1950); H.R. REP. NO. 81-2319 (1950).

257. I.R.C. § 62(a)(4) provides as follows:

(a) GENERAL RULE.—For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

...

(4) DEDUCTIONS ATTRIBUTABLE TO RENTS AND ROYALTIES.—The deductions allowed by part VI (sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents and royalties.

I.R.C. § 62(a)(4) (2000). The taxpayer will get the full benefit of the deduction because the taxpayer may deduct the rent and royalty expenses directly against the gross income in order to calculate adjusted gross income. Although investment expenses usually are itemized deductions

itemized deductions.<sup>258</sup> (Trade or business expenses are deducted from gross income whereas investment expenses are itemized deductions.). However, Congress was not necessarily taking the position that rental and royalties are a trade or business. Congress is free to exercise its prerogative to have those expenses treated as if they arose from the operation of a trade or business and, therefore, deductible from gross income<sup>259</sup> without necessarily having to make a determination as to whether royalties are trade or business, investment, or some other kind of income.

The structure of I.R.C. Section 512 and its supporting regulations appear to recognize that differences exist between dividends and interest, which no one would argue are not investment income, and rents and royalties, the status of which is not as clear. I.R.C. Section 512(b)(1) exempts dividends and interest from the unrelated business income tax; I.R.C. Section 512(b)(2) exempts royalties. They are not lumped together, but are addressed separately. Similarly, Treasury Regulation Section 1.512-(b)(1)(a) addresses the treatment of dividends and interest; 1.512-(b)(1)(b) addresses royalties; and 1.512-(b)(1)(c) addresses rents. Neither the statute nor the regulation lumps them together as "investment income," treating them as a monolithic category. This also reflects Congress's uncertainty as to the exact nature of royalties, and we simply may be unable to determine if they are fish or fowl—business or investment income. Therefore, it is a useless exercise to attempt to resolve their status under the unrelated business income tax on that basis.

A more fruitful approach would be to compare these "new" royalties to traditional mineral rights royalties, which no one disputes are exempt from the

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(I.R.C. §§ 67, 68, 212) that receive less favorable treatment because they are not deducted in full, Congress permits taxpayers to deduct expenses associated with rents and royalties directly against gross income, treating them as trade or business expenses. Congress does not distinguish between investment and trade or business expenses in this situation.

258. I.R.C. §§ 63(d) and 212 permit a taxpayer to deduct, as an itemized deduction, investment expenses. I.R.C. § 63(d) allows the taxpayer to deduct itemized deductions in lieu of the standard deduction; therefore, the taxpayer will only itemize the deductions if their total amount exceeds the standard deduction. I.R.C. §§ 67–68 impose additional limits on the amount that the taxpayer may deduct.

259. *See, e.g., Lewyt Corp. v. Comm'r*, 349 U.S. 237, 240 (1955) (concerning congressional power to allow deductions). The Court writes:

Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.

*Id.*

unrelated business income tax. Congress excluded these traditional royalties for a reason. Something about their nature or derivation did not raise concerns about unfair competition. The question then becomes, are these new royalties generated in a manner that is similar to traditional royalties? If so, this would be a workable and appropriate method for classifying the new royalties for purposes of determining whether they should be exempt from the unrelated business income tax.<sup>260</sup>

### C. *The Similarities Between Affinity Card and Mailing List Arrangements and Overriding Royalties*

#### 1. *Mineral Royalties in General*

Mailing list rental and affinity card arrangements operate in a manner similar to overriding royalties from mineral, oil, and gas leases. I.R.C. Section 512(b)(2) removes royalties, including overriding royalties, from the unrelated business income tax.<sup>261</sup> The term "royalty" with regard to mineral, oil, and gas leases can be defined as a share of the product or profit reserved by the landowner for permitting the lessee to use the property.<sup>262</sup> An "overriding royalty" usually refers to an interest carved out of the lessee's share, as opposed

260. It is arguable that this approach could be applied to all items of income to determine whether it is appropriate to exclude them from the unrelated business income tax under § 512(b). Mineral rights royalties are divided into a taxable working interest, which bears the risk and benefits of the venture, and the exempt investment interest held by the nonprofit. This distinction between a working interest and an investment interest really is at the heart of the exemptions for interest and dividend income from the unrelated business income tax.

261. I.R.C. § 512(b)(2) (2000). The statute states:

There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

*Id.*

262. See 58 C.J.S. *Mines and Minerals* § 289 (1998) (offering several definitions for royalty). It also offers the following definitions:

It has also been defined as the amount reserved or the rental to be paid the original owner of the whole estate; the compensation for the privilege or right created by the lease; the compensation provided for the privilege of drilling for oil and gas, consisting of a share in the oil and gas produced under existing leases; a participation in the proceeds derived under the terms of the lease; the share of the product or profit paid to the owner of the property . . . .

*Id.* (citations omitted). In *Sierra Club, Inc. v. Commissioner*, the Ninth Circuit employed a similar definition: "[R]oyalty commonly refers to a payment made to the owner of property for permitting another to use the property." *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1531 (9th Cir. 1996).

to the landowner's or lessor's interest or royalty.<sup>263</sup> The lessee may choose to divide the lease interest into (1) a working interest, which will be responsible for the actual business operations such as developing and marketing the oil and gas, and (2) an overriding royalty. For example, in return for a royalty, a landowner might enter into an agreement with a lessee in which the lessee agrees to develop and produce oil and gas from deposits on the landowner's property. The lessee in turn might enter into an agreement with a third party who will actually perform the work and pay the lessee an overriding royalty. The third party has a working interest; the lessee will be entitled to an overriding royalty. Both a royalty and an overriding royalty are nonrisk and noncost bearing interests.<sup>264</sup> In *Garmon v. Conoco, Inc.*<sup>265</sup> the court explained the various interests:

The fundamental purpose of an oil and gas lease is to provide for the exploration, development, production and operation of the property for the mutual benefit of the lessor and lessee . . . . The lessor relinquishes its right to the mineral estate in exchange for a smaller non-risk and non-cost bearing royalty interest in any mineral discovered . . . . Similar to a royalty, an overriding royalty is an interest in oil and gas produced at the surface, free of expense of production, generally assessed in addition to the usual mineral owner's royalty. . . . Though their contractual origins may differ, both royalty and overriding royalty interests are non-risk and non-cost bearing interests. . . .

Though a lease is entered into for the mutual benefit of the parties, not all parties participate equally in lease development decisions. Royalty and overriding royalty interest owners (nonworking interest owners) defer to the risk-bearing parties (working interest owners) to decide when and where to drill, the formations to be tested and ultimately whether to complete a well and establish production.<sup>266</sup>

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263. See 58 C.J.S. *Mines and Minerals* § 289 (1998) (describing "overriding royalty"); 38 AM. JUR. 2d *Gas and Oil* § 215 (1999) (defining overriding royalty). American Jurisprudence writes:

An overriding royalty has also been defined as a certain percentage of the working interest which, as between the lessee and the assignee, is not charged with the cost of development or production. An overriding royalty is similar to a royalty in that both are nonrisk and noncost bearing interests . . . .

*Id.*

264. See 58 C.J.S. *Mines and Minerals* § 289 (comparing an overriding royalty and a royalty).

265. *Garmon v. Conoco*, 886 P.2d 652 (Colo. 1994).

266. *Id.* at 656–57.

## 2. Mineral Royalties and the Unrelated Business Royalty Exception

With regard to tax-exempt organizations, Treasury Regulation Section 1.512(b)-1(b) specifically provides for the exclusion of mineral royalties from the unrelated business income tax, with the caveat that an exempt organization holding a working interest and not relieved from its share of development costs cannot exclude the income.<sup>267</sup> The Internal Revenue Service in a Technical Advice Memorandum further explained the working interest must not be able to look to the tax-exempt organization for reimbursement or liability for operating or development expenses in order for the tax-exempt organization to be able to exclude any income as an overriding royalty.<sup>268</sup>

Section 1.512(b)-1(b) of the regulations, in conjunction with Rev. Rul. 69-179, indicates that a mineral interest is a royalty interest for purposes of section 512(b)(2) of the Code if the holder of the mineral interest is not liable for the expenses of development or operations. The holder of a mineral interest is not liable for the expenses of development or operations within the meaning of section 1.512(b)-1(b) where the holder's interest is a net profit interest not subject to expenses which exceed gross profits.<sup>269</sup>

What is key is that the tax-exempt organization is relieved of all risks and expenses associated with the exploitation of the intangible.

Sierra Club's risk and responsibilities under the affinity card program were similar to those of a holder of an overriding royalty with the bank or promoter serving as the working interest. Sierra Club was not responsible for the expenses associated with marketing the card but rather had a nonrisk, noncost bearing interest.<sup>270</sup> In addition, the bank or the third party promoter was responsible for the day-to-day operations of the program, not Sierra Club; the program's success depended on their efforts, not Sierra Club's.<sup>271</sup> Sierra

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267. Treas. Reg. § 1.512(b)-1(b) (2004). The regulation states in pertinent part: Royalties, including overriding royalties . . . shall be excluded in computing unrelated business taxable income . . . . Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded.

*Id.*

268. Tech. Adv. Mem. 77-41-004 (1977).

269. *Id.*

270. *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307, 325 (1994) ("None of the agreements provide that petitioner is to bear a share of either (1) Chase Lincoln's cost of funds, (2) losses on account of uncollectible accounts, or (3) any direct or overhead costs.")

271. *See id.* at 326-27 (discussing the limits of Sierra Club's duties, obligations, and

Club's receipt of royalty payments depended on the bank's and the promoter's marketing efforts, not Sierra Club's.

The rationale the Tax Court employed in *Sierra Club II* for distinguishing affinity card arrangements from joint ventures parallels the rationale for distinguishing between working interests and overriding royalty interests. The Tax Court looked to which party bore the risk of loss or rewards and which party was responsible for development and marketing, which in the mineral lease area would indicate which party held the working interest. The Tax Court found that the bank or the promoter shouldered the risk of loss, not Sierra Club.<sup>272</sup> Further, the Tax Court found that the bank or the promoter was responsible for soliciting and marketing the affinity cards; Sierra Club did not share control over those activities.<sup>273</sup>

Likewise, with regard to Sierra Club's mailing list rentals, the parties' respective risks and responsibilities could be divided between a working interest and an overriding royalty. Again, Sierra Club was dependent on the list manager's and list broker's successful efforts to rent the list. The list manager and list broker had the responsibility for the day-to-day activities associated with renting the list, such as finding potential renters.<sup>274</sup> If they were unsuccessful or if their expenses exceeded their commissions, they bore the risk of loss, not Sierra Club.<sup>275</sup>

### 3. *The Working Interest, the Royalty Interest, and Services*

In *Robert A. Welch Foundation v. United States*<sup>276</sup> the plaintiff was a tax-exempt trust (Foundation) that received a significant portion of its funds from

opportunities under the contract).

272. *Id.* at 326–27. The court wrote:

Significantly, petitioner did not share any of the credit risk borne by Chase Lincoln. Also, petitioner did not share in (1) any of Chase Lincoln's direct costs or overhead costs, or (2) any of the costs of solicitation borne by [the third party promoter]. Petitioner bore no costs (other than its own). . . . Simply put, petitioner's participation in the financial risk and reward factors . . . was too limited to constitute a mutual proprietary interest in the net profits of that activity. The . . . agreement entitled petitioner to contingent compensation, measured in chief by total cardholder sales volume.

*Id.*

273. *Id.* at 328 ("[The promoter] is made responsible for the development of promotional and marketing materials and programs.").

274. *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582, 2583 (1993).

275. *Id.*

276. *Robert A. Welch Found. v. United States*, 228 F. Supp. 881 (S.D. Tex. 1963).

two controlled subsidiaries.<sup>277</sup> The two subsidiaries produced and marketed oil and gas from properties on which they held oil and gas leases and paid Foundation an overriding royalty of all of the net profits.<sup>278</sup> With some minor exceptions, Foundation was not responsible for any of the subsidiaries' expenses that exceeded revenues derived from the oil and gas leases; the subsidiaries could only look to the income for reimbursement.<sup>279</sup>

The Internal Revenue Service claimed that the overriding royalties that Foundation received were working interests, not overriding royalties, and were subject to the unrelated business income tax.<sup>280</sup> Foundation filed a timely claim for a refund and prevailed.<sup>281</sup> The district court held that the royalties were overriding royalties and exempt from tax under Section 512(b). Specifically, the court held that the holder of the overriding royalty does not operate a trade or business; the working interest, which is responsible for the day-to-day operations of developing and marketing the oil and gas, operates a trade or business.

An overriding royalty on oil and gas properties, such as were held by the plaintiff under said Contracts No. 1, 2, and 3, are entirely different from working interests owned by the holder of an interest in an oil and gas lease who drills the wells and operates the properties for the production of oil and gas. The owner of such a working interest is actively engaged in his operations at all times and such operations under a working interest are definitely the carrying on of a trade or business. This is so clear that citation of authorities is unnecessary. On the other hand, the owner of an overriding royalty such as was held by the plaintiff is not engaged in any operations for the production of oil or gas. All of the operations in this case by which the oil and gas on account of which the plaintiff received its royalty income were carried on by [the subsidiaries]. As stated by the Circuit Court of Appeals for the Fifth Circuit in *Snell v. Commissioner of Internal Revenue*, 97 F.2d 891, in speaking of the meaning of "business:"

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277. *See id.* at 882–84 (discussing the history of Mound Company and Fidelity Oil and Royalty Company).

278. *Id.* at 883.

279. *See id.* at 884 ("Fidelity being required to look only to the income for reimbursement.").

280. *See id.* at 885 ("The Commissioner . . . held that said interests . . . were not royalties but were working interests.").

281. *See id.* at 888 (granting the plaintiff recovery for overpayment of taxes plus prejudgment interest). The decision of the district court was upheld on appeal to the Fifth Circuit in *United States v. Robert A. Welch Found.*, 334 F.2d 774 (5th Cir. 1964).

The word, notwithstanding disguise and spelling and pronunciation, means business; it implies that one is kept more or less busy, that the activity is an occupation.

The plaintiff through its ownership of these overriding royalties was not kept busy in the sense of operating a business. Consequently, the plaintiff was not through the ownership of these overriding royalties engaged in such a business as comes within the meaning of unrelated trade or business as defined by Section 513 . . . .<sup>282</sup>

In part because of the *Welch Foundation* case, Congress amended I.R.C. Section 512 in 1969 by adding I.R.C. Section 512(b)(15), which provides that an exempt organization that receives royalties including overriding royalties from controlled organizations, such as subsidiaries, will pay unrelated income tax on the royalty.<sup>283</sup> However, exempt organizations still may receive income exempt from tax royalties and overriding royalties from unrelated entities.<sup>284</sup>

In attempting to resolve whether the exempt organization had derived its income from a royalty, the courts focused on whether the exempt organization was "too active" or whether the royalty was from "passive" activity.<sup>285</sup> The courts sensed that somewhere in all that activity a trade or business existed—the issue was *who* was operating the trade or business. It is significant that in *DAV I* and *DAV II* the courts spent little time focusing on the role and responsibilities of the entities with whom the exempt organization had contracted.<sup>286</sup> If the courts had studied how an overriding royalty functions,

282. *Id.* at 887.

283. See H.R. REP. NO. 91-413, at 49 (1969), reprinted in 1969 U.S.C.C.A.N. 1645, 1694 (concerning provisions of the bill). The House Report states:

In certain cases exempt organizations do not engage in business directly but do so through nominally taxable subsidiary corporations. In many such instances the subsidiary corporations pay interest, rents, or royalties to the exempt parent in sufficient amount to eliminate their entire income, which interest, rents, and royalties are not taxed to the parent even though they may be derived from an active business.

*Id.* This problem is remedied under the bill by removing the exemption from the unrelated business tax for passive income if it is in the form of interest, rents, and royalties received from controlled corporations. *Id.*

284. See Tech. Adv. Mem. 77-41-004 (1977) (finding "net profits interests" to be royalties in the context of mineral interests).

285. See, e.g., *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 61 (1990) (framing the question of unrelated business taxable income liability as turning on whether income was a royalty or a rental).

286. See generally *id.*; *Disabled Am. Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981).



they would have had a method or structure for sifting out and assigning the risks and responsibilities under the contract to the appropriate party—to the owner of the intangible or to the party wishing to use the intangible. If the owner of the intangible (the exempt organization) does not assume responsibility for expenses that exceed gross receipts or for the day-to-day operations involved in marketing the intangible, the exempt organization's interest is akin to an overriding royalty. In *DAV I*, the exempt organization did not enter into a contract with a promoter but marketed the mailing list directly to ultimate users.<sup>287</sup> DAV directly participated in the mailing list rental business, and, in fact, its employees devoted two man-years to the activity.<sup>288</sup> Therefore, DAV was both the owner and the promoter of the valuable, intangible property right. In *DAV II*, the Tax Court only focused on who was the owner of the property right and did not consider who was performing the marketing.<sup>289</sup> To some extent, the Tax Court in *Sierra Club I* and *Sierra Club II* stumbled into that methodology without realizing it and looked to the risks and responsibilities of the respective parties to the contract, ending up with a correct result.<sup>290</sup>

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287. See *Disabled Am. Veterans*, 650 F.2d at 1184–85 (describing DAV's practice of renting out its mailing lists).

288. See *id.* at 1182 (discussing DAV's efforts to create and maintain its mailing list).

289. See *Disabled Am. Veterans*, 94 T.C. at 75–76 (rejecting the contention that DAV's actions as its own marketer of its list converted a royalty into a rental).

290. However, the Tax Court did not employ this methodology of determining which party bore the risks and was responsible for the success of the program when deciding *Common Cause v. Comm'r*, 112 T.C. 332 (1999). As in *Sierra Club I*, Common Cause employed third parties to market and to maintain the list and to fill rental orders. *Id.* at 335. Common Cause's only direct activity (other than owning the rental list) was to review the data cards and approve list rentals. *Id.* at 334–36. The Tax Court held that these actions were appropriate for the owner of a valuable intangible to take in order to protect the value of the intangible and did not constitute "services." *Id.* at 342. However, the Tax Court then considered whether the activities conducted by (1) the computer service that actually maintained the list and filled orders, (2) the list manager that marketed the list, and (3) the list broker that helped consummate sales were "royalty-related activities." *Id.* at 342–47. These three entities all charged fees for their services, which were included in the invoice sent to the list renter. *Id.* at 337. When the list renter paid the bill, they all received payment, and Common Cause received the balance. *Id.* The Tax Court held that the list broker's activities, such as coordinating the rental and collecting payment from the renter, to remit to the list manager were not royalty-related because they were undertaken "solely for the mailers' convenience." *Id.* at 346. However, the Tax Court proceeded to hold that the computer service's activities, such as printing the list on media chosen by the renter, and the list manager's activities, such as advertising the list to list brokers and renters, were not services but were royalty-related activities because they were designed "to exploit or protect [the] list." *Id.* at 342. It is difficult to understand the Tax Court's logic, although clearly it did not want to determine if these activities were a trade or business: "Our holding obviates the need to address respondent's trade or business arguments." *Id.* at 347. Nevertheless, it is clear that these entities were active participants in and offered their services to

However, it is possible for the exempt organization to have an overriding royalty interest and also have income from services. Even if the exempt organization has entered into a contract with another entity that has the working interest, it is still possible for the exempt organization to have income from services. One explanation for the differing outcomes in *DAV I* and *DAV II* is that the Court of Claims focused on how DAV's activities made the list more marketable, and the Tax Court emphasized how DAV's activities furthered DAV's exempt purpose.<sup>291</sup> Neither court, nor the Internal Revenue Service, fully recognized that it was possible for an exempt organization to have income from both (1) the use of property and (2) the rendering of services. The Tax Court concerned itself with whether the mailing list was a valuable intangible property right in light of Revenue Ruling 81-178's more expansive view of a royalty and gave little thought as to whether DAV also was rendering services.<sup>292</sup> The Court of Claims gave scant consideration to whether DAV was receiving income from the use of a valuable property right, directing its attention instead to the question of whether DAV was rendering services.<sup>293</sup>

In order to determine from which source the income arises, it is necessary to examine the exempt organization's activities and to put them into categories. The activities can be separated into three categories: (1) those the exempt organization would undertake regardless of whether it rented the mailing list (for example, updating the names), (2) those necessary and ancillary to exploit the intangible to obtain a royalty (for example, providing a renter with a computer disk containing the names or reviewing literature the renter intended to send to potential contributors), and (3) those that are services solely for the benefit of the renter (for example, if DAV were to perform the actual mailing for the renter for a fee). Admittedly, the lines of demarcation among these three categories are not always clear. For example, one could argue that DAV's provision of mailing labels in lieu of

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the mailing list industry in return for payment. *Id.* at 343-44. They functioned as working interests, and they did not act as mere royalty holders. See generally *Planned Parenthood v. Comm'r*, 77 T.C.M. (CCH) 2227 (1999) (consolidating the case for trial with *Common Cause* and is virtually identical with *Common Cause*).

291. See *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 73 (1990) (noting that DAV's actions to maintain the productiveness of its list was directly related to its own ability to solicit funds).

292. See *id.* at 70-71 (discussing the application of Revenue Ruling 81-178 in determining whether the DAV's mailing list was a royalty).

293. See *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1189 (Ct. Cl. 1981) (describing DAV's business activities as "extensive").

simply providing a computer tape with the names belongs in either the second or third category.

Both the Internal Revenue Service and the Court of Claims said that DAV had engaged in "too much" activity.<sup>294</sup> They failed to recognize that the issue is not the extent of the activity but its purpose. They did not sort the activities into categories. The Tax Court to some extent did recognize that the purpose underlying the activity is relevant and directed its attention towards identifying those activities that made the list more valuable to DAV (and only incidentally to the renters), such as updating and segmenting the list, which would fit under the first category.<sup>295</sup> However, the Tax Court did not address DAV's other activities, such as providing labels for the convenience of the renter or DAV's marketing activities, which belong in the second and third categories.<sup>296</sup>

The Ninth Circuit distinguished *Sierra Club I* and *DAV I* on the basis that DAV had performed a number of the services (such as list maintenance) directly, whereas *Sierra Club* had used third parties to provide rental services.<sup>297</sup> The Ninth Circuit held that because *Sierra Club's* activities were "far less substantial" than activities that other courts had found would prevent a claim that income was royalty income.<sup>298</sup> The Ninth Circuit mistakenly focused on the extent of the activities or services and not on the nature or purpose of the activities or services.<sup>299</sup>

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294. See *id.* at 1188 (discussing the difference between regular and intermittent activities); see also *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 79 (1990) (Swift, J., dissenting) (same).

295. See *Disabled Am. Veterans*, 94 T.C. at 78 (describing services associated with renting segments of the DAV list as de minimis in light of DAV's internal segmenting of its list to increase donations for itself).

296. See *id.* at 73-74 (listing several factors raised by the IRS and dismissing same as irrelevant).

297. See *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1535-36 (9th Cir. 1996) (discussing and distinguishing *DAV I* from *Sierra Club I*).

298. See *id.* at 1536 (dismissing the IRS position that directly paying for a business service and allowing a commission to be deducted for such services are functionally equivalent).

299. Subsequent to *Sierra Club I* and *II*, and the appeal of *Sierra Club II*, the Tax Court also decided *Alumni Association of University of Oregon v. Commissioner*, 71 T.C.M. (CCH) 2093 (1996), *Oregon State University Alumni Association v. Commissioner*, 71 T.C.M. (CCH) 1935 (1996), and *Mississippi State University Alumni v. Commissioner*, 74 T.C.M. (CCH) 458 (1999), two of which were appealed to the Ninth Circuit. The Oregon affinity credit card arrangements were upheld as constituting royalty payments, based on *Sierra Club* and the Ninth Circuit's decision in *Sierra Club*. *Ore. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098, 1100-02 (9th Cir. 1998).

V. *Why Taxing Mailing List and Affinity Card Income Does Not Comport with Good Tax Policy*

A. *The Harm to Competition Rationale*

Both the Internal Revenue Service and the courts have scrutinized the legislative history to determine whether Congress would have considered affinity card and mailing list rental income to be within the royalty exception. This scrutiny is misplaced and does not resolve the issue. I.R.C. Section 512(b) was enacted more than fifty years ago when the United States's economy was based on manufacturing and not services as it is today. It simply would not have been within Congress's contemplation that the concept of a royalty could be extended to include the property at issue because those situations did not exist. Therefore, it is impossible to glean from the legislative history whether Congress would or would not have included mailing list rental and affinity card income within the unrelated business income tax. A more fruitful approach is to consider whether mailing list rentals and affinity card income creates the potential for the kinds of abuse that Congress intended to prohibit. Congress was concerned that exempt organizations would engage in unfair competition, divert resources, or enter into risky business ventures.

An exempt organization that operates a business and does not pay taxes has lower costs that gives it an unfair advantage over commercial entities. An exempt organization operating as efficiently as a commercial entity will have higher profits that can be plowed back into the business to expand it. The exempt organization also can afford to operate less efficiently than a commercial counterpart and to remain competitive as long as the cost of the inefficiency is less than the cost of the taxes not paid. If exempt organizations directly engaged in the marketing of affinity cards or, as was the case in *DAVI*, competed with other list brokers and list managers to market its mailing list, the risk of unfair competition would exist. The exempt organizations could operate more cheaply than their commercial counterparts.

However, when the affinity card or mailing list rental arrangements are akin to overriding royalties, the exempt organization does not compete directly against commercial enterprises. In that case, the danger of unfair competition would exist only if the exempt organization could pass along the benefit of its tax-exempt status to the commercial entity with which it has the arrangement, enabling it to compete unfairly.

With regard to affinity cards, the financial institution with the affinity card agreement would have an unfair advantage only if the institution had lower costs as a result of the agreement and other financial institutions did not have

access to such agreements. There is no evidence that access to affinity card agreements is limited. More importantly, however, it is difficult to see how the exempt organization's exempt status could enable the financial institution to operate more cheaply. In fact, the financial institution would have increased costs because it has to pay the exempt organization a fee. The financial institution benefits from the goodwill associated with the exempt organization's name, not from the exempt organization's exempt status. A consumer's incentive to use the card arises from the consumer's desire to support the exempt organization, not because the card is necessarily cheaper than one not associated with the organization.

The potential for unfair competition from mailing list rentals would occur only if the exempt organization could pass on the benefit of its exempt status either to list brokers or to list renters who competed against brokers and renters who did not have access to the lists. It is difficult to see how an exempt organization could pass on the benefit of its exempt status to give list brokers or users a competitive advantage. List brokers operate on commission, meaning that their fees are based on a percentage of the list rental fee.<sup>300</sup> If the exempt organization were to set a rental charge that was below market rates, the broker would have less incentive to market the exempt organization's mailing list because the broker's commission would be reduced.

Further, the exempt organization would not have any incentive to charge less than the market rate for list rentals. Exempt organizations rent these lists to raise funds, and therefore, the exempt organization has no incentive to rent the list below market rates. If the exempt organization were to do so, it would fail to collect all the revenue that would be available to it with no offsetting benefit from having foregone the revenue. In addition, the only incentive an exempt organization would have to restrict access to its list would be if the exempt organization considered the renter to be incompatible with the exempt organization's exempt purpose, but otherwise, the exempt organization would want to rent the list as often as possible. The Court of Claims in *DAVI* found that each mailing list is unique so that any one list does not compete directly with another list for rental income.<sup>301</sup> The same could be said for names and logos on affinity cards.

Congress also was concerned that exempt organizations engaging in unrelated trades or businesses would be diverting their resources from their

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300. See *supra* Part III.A (discussing the mailing list rental industry).

301. See *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1187 (1981) ("While mailing lists are each unique such that it cannot be said that any one list competes against any other list . . .").

exempt purpose, which also can raise unfair competition issues.<sup>302</sup> Frances Hill has observed that there is an assumption that exempt organizations apply their revenues towards their exempt purpose, but in fact, there is no way to verify that they do.<sup>303</sup> Because a nonprofit is prohibited from passing on its revenues to shareholders or owners, it is assumed that the revenues are devoted to exempt purposes, which is not necessarily the case.<sup>304</sup>

An exempt organization will engage in an unrelated trade or business only if it were economically self-sufficient, that is, if the unrelated trade or business generates sufficient revenue to cover its costs. In that case, the exempt organization would not divert funds it derived from fulfilling its exempt purpose, such as donations, to maintain the unrelated trade or business. However, the exempt organization could divert funds to expand the business. The exempt organization also could use the profits from the unrelated trade or business to expand its operations rather than applying the funds towards fulfilling its exempt purpose.

Mailing list rentals and affinity card arrangements that operate like overriding royalties do not present this danger. The exempt organization's name, logo, and mailing list have intrinsic value only because of the goodwill of the exempt organization's supporters, and that goodwill is generated by the exempt organization fulfilling its mission. The only way that the exempt organization could increase the number of affinity cardholders or names on its mailing list would be for the exempt organization to acquire more supporters; the exempt organization gains supporters by fulfilling its mission. Affinity cards and mailing lists are desirable only if the exempt organization fulfills its purposes and gains supporters. There are two components to the successful marketing of mailing lists and affinity cards—the existence of a valuable property right and the successful development or marketing of the property right. These two components are akin to the two interests associated with overriding royalties—the owner of the valuable property right (the recipient of the overriding royalty payment) and the developer or marketer of the valuable property right (the working interest). The intrinsic value of the intangible depends on the exempt organization fulfilling its mission; the successful

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302. H.R. REP. NO. 91-413, at 27 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1672 (expressing concern about potential unfair competition issues).

303. See Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675, 687 (2003) ("[P]art of the problem is a pervasive assumption that revenue from all sources is used for exempt activities.").

304. See *id.* at 680 ("Virtually no data exist on how exempt organizations use their resources.").

marketing of the mailing list or affinity card depends on the respective efforts of the list broker or the financial institution—the working interest.

*B. Taxing Income Impedes Ability of Some Nonprofits To Function and Discriminates Unfairly*

Exempting mailing list and affinity card income from taxation does not create the potential for harm to competition; however, subjecting that income to taxation could have a deleterious effect on the ability of some nonprofits to function. Taxing mailing list and affinity card income will impede the ability of some exempt organizations to raise revenue. There is a tendency to view exempt organizations as a homogenous group when in fact there are twenty-seven separate categories of organizations with tax-exempt status, many with nothing more in common than the fact that their earnings cannot inure to private benefit.<sup>305</sup> As discussed below, conventional revenue sources such as fees for services or donations are more readily available to some exempt organizations than others.

Exempt organizations derive revenues from program service revenues, donations, government grants, membership dues, and commercial activity. When viewed as a group, the primary source of funds for nonprofit organizations is program service revenue, which is mostly comprised of fees that organizations collect from the activities they operate in furtherance of their exempt purposes.<sup>306</sup> Typical examples of program service revenue are college tuition, museum admission fees, and hospital care charges. The bulk of program service revenue is earned by universities and hospitals; it is the main source of revenue for hospitals.<sup>307</sup> Not all exempt organizations can generate program service revenues (for example, soup kitchens and homeless shelters).

I.R.C. Section 501(c)(3) charities now receive the bulk of private contributions and grants. In 1995, of the almost \$125 billion that exempt organizations received from donations and grants, \$119 billion went to I.R.C. Section 501(c)(3) charities.<sup>308</sup> Given that contributors may deduct donations to Section 501(c)(3) charities on their tax returns, it is not surprising that they are

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305. I.R.C. §§ 501(c)(1)–(27) (2000). The twenty-seven subsections provide that no part of the net earnings of the exempt organization may inure to the benefit of any private shareholder or individual.

306. STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, 20-YEAR REVIEW OF THE NONPROFIT SECTOR, 1975–1995, at 153 (1999).

307. *Id.*

308. *Id.* at 171.

more attractive recipients of contributors' largesse. Jennifer Anne Spiegel has suggested that if an exempt organization cannot raise sufficient funds from donations, perhaps it does not merit tax-exempt status.<sup>309</sup> However, one of the reasons exempt organizations are formed and we support them is because they give voice to minorities.<sup>310</sup> A group with substantial support from the public has the clout to get what it wants from the private sector or the government.

Heather Gottry documents that the federal government has decreased its financial support for exempt organizations while at the same time expecting exempt organizations to carry out functions that formerly the federal government performed.<sup>311</sup> At the same time, the number of exempt organizations has increased dramatically in the last twenty years, and there are now 1.2 million nonprofit organizations registered with the Internal Revenue Service.<sup>312</sup>

309. Spiegel, *supra* note 223, at 1730. Spiegel writes:

Soliciting contributions serves a dual purpose of generating revenue and encouraging society to contemplate the value of the services of the exempt organization. An exempt organization's inability to muster minimal support through charitable donations may indicate that society no longer values the services of the exempt organization. If society no longer places a high priority on these services, then perhaps the tax-exempt status of the organization is no longer justified.

*Id.*; see also Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 72–75 (1981) (observing that donations are often an uncertain and inadequate source of capital for nonprofit organizations).

310. LESER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 11–13 (2d ed. 1999), reprinted in JAMES J. FISHMAN & STEPHEN SCHWARZ, *TAXATION OF NONPROFIT ORGANIZATIONS* 34 (2003). Salamon writes:

But in a democracy government will only supply those collective goods desired by a majority. Where such support is lacking, another mechanism is needed, and one such mechanism is the nonprofit sector. Nonprofit organizations allow groups of individuals to pool their resources to produce collective goods they mutually desire but cannot convince a majority of their countrymen to support. This can happen, for example, when particular subgroups share certain cultural, social or economic characteristics or interests not shared by all or most citizens of a country. Through nonprofit organizations such subgroups can provide the kinds and levels of collective goods they desire. The greater the heterogeneity of the population, therefore, the larger the nonprofit sector is likely to be.

*Id.*

311. See Heather Gottry, *Profit or Perish: Non-Profit Social Service Organizations and Social Entrepreneurship*, 6 GEO. J. ON POVERTY L. & POL'Y 249, 254 (1999) (noting the implications of increased emphasis on nonprofit service organizations combined with reduced federal financial support). Additionally, nonprofit organizations were "projected to lose up to ninety billion dollars of their federal support over the fiscal years 1997–2002, including at least a 25% reduction in overall funding for social service organizations." *Id.* at 255.

312. DIVISION, INTERNAL REVENUE SERVICE, 20-YEAR REVIEW OF THE NONPROFIT SECTOR,



Exempt organizations have been forced to devise new methods for raising funds, such as generating income from the use of their most valuable assets—their names, logos, and mailing lists. Taxing this royalty income but not "traditional" royalty income such as income from oil and gas leases favors certain groups of nonprofit organizations over others, even though such favoritism is not intended or desirable. For example, long-established colleges have endowments that can be invested in traditional royalties. Younger schools do not have that economic advantage but need revenue to carry out the same function that the older schools do. Exempt organizations require a steady stream of income in order to plan.

Affinity cards and mailing list rentals also assist exempt organizations in the fulfillment of their respective exempt purposes in ways that are perhaps more subtle than the direct infusion of cash but are nevertheless very real. When a consumer acquires and uses an affinity card bearing the name and logo of a particular nonprofit organization, the consumer displays support for and promotes the organization's purpose. The card also keeps the nonprofit organization's name in both the consumer's and the public's awareness, which may increase donations or at least sensitivity to the organization's message. The alumni organization in *Oregon State University Alumni Association v. Commissioner*<sup>313</sup> made such an argument when successfully resisting attempts by the Internal Revenue Service to tax the university's affinity card income.<sup>314</sup>

## VI. Conclusion

Congress's and small business owners' concerns about nonprofit organizations engaging in commercial activities is warranted; situations where nonprofit organizations abuse their exempt status exist. However, Congress should tread carefully if it decides to amend the unrelated business income tax provisions to include within its sweep only those activities in which the exempt organization is abusing its status. Affinity credit card licensing agreements and mailing list rentals do not present the potential for abuse (unfair competition, diversion of resources, or risky ventures) with which the 1950 Congress was concerned. Instead, these two revenue raising activities operate very similarly to overriding royalties, which have long been considered an appropriate revenue source for nonprofit organizations.

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1975–1995, at 150 (1999).

313. *Ore. State Univ. Alumni Ass'n v. Comm'r*, 71 T.C. M. (CCH) 1935 (1996).

314. *See id.* at 1936 (listing the association's motivations as primarily related to publicity and only secondarily related to income).

The working interest—the commercial entity with whom the exempt organization has an agreement—would remain subject to tax. The nonprofit itself, which represents the overriding royalty interest, would not be directly competing with commercial enterprises and, therefore, would not be able to use its exempt status to an unfair advantage. In addition, the nonprofit is not able to pass on the benefit of its exempt status to the working interest, enabling it to compete unfairly with other commercial enterprises.

Further, if Congress were to subject affinity credit card licensing agreements and mailing lists rentals to taxation, it would cripple the ability of some nonprofits to fulfill their missions. Nonprofits need to be able to depend on a steady stream of income in order to plan effectively; however, not all nonprofit organizations have endowments that can be invested in "traditional" royalties but must devise new methods for generating a steady stream of income. To permit nonprofits to receive income streams from mineral royalties, but not from the exploitation of their valuable, intangible property, would discriminate unfairly between nonprofits. At the same time, such discrimination would not protect competition.



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