December 22, 1988

Summary of Comments of D.C. Bar Section of Taxation on the Draft Report of the House of Representatives Ways and Means Committee's Oversight Subcommittee Describing Recommendations on the Unrelated Business Tax

1. Any proposals which are adopted should provide for transition or grandfather rules and prospective dates.

2. The Section of Taxation agrees with the proposal in the Subcommittee's Draft Report Describing Recommendations on the Unrelated Business Income Tax to modify the royalty exclusion so as to apply the unrelated business income tax ("UBIT") to royalties measured by net or taxable income derived from the licensed property. However, where an exempt organization provides its mailing list to a for-profit entity in connection with an affinity program, a separate allocation should be made of the income derived from the transfer of the mailing list, consistent with current law.

3. The three-tier approach proposed by the Oversight Subcommittee for the allocation of expenses for dual-use facilities is conceptually flawed. It gives taxable organizations a competitive advantage over tax-exempt organizations. A different objective standard is proposed by the Section of Taxation.

4. The Section of Taxation agrees with the approach suggested in the Draft Report for computing net advertising income subject to UBIT, provided that such approach allows exempt organizations to deduct an allocable portion of fixed, as well as marginal, costs.

5. The specific deduction should be increased to $10,000 for all exempt organizations and all types of unrelated income. The deduction should be indexed to the CPI. A phase-out should commence at $25,000, rather than at the proposed $50,000 figure.

6. Donee gifts of nominal value, defined as $10 or less, should not reduce the amount deductible under IRC section 170.

7. The Section of Taxation does not believe that the mere existence of subsidiaries of an exempt organization is an abusive situation. It, therefore, disagrees with any attempt to attribute a subsidiary's activities to a parent organization based solely on a specified level of ownership. The current law, which applies to both taxable and tax-exempt entities, is better adapted to preventing abuses than any arbitrary affiliation rule would be. If, nevertheless, Congress is in favor of an affiliation rule, then the Section of Taxation recommends that any aggregation rule be supplemented with a safe harbor based on a parent's annual investment in its taxable subsidiaries. The permissible percentage would be not more than 50 percent of the parent's annual revenues.

8. The Section of Taxation supports the draft recommendation that control of a subsidiary be defined as a 50-percent interest in a subsidiary, held directly or by attribution, as measured by either voting power or value.

TAXATION SECTION

Steering Committee:

Jane C. Bergner, Chair
Collette C. Goodman
Ellen A. Hennessy
Gerald A. Kafka
Stephen A. Nauheim
Lawrence J. Ross
Bradley M. Seltzer

The District of Columbia Bar

Committees:

Business Related Taxes
Employee Benefits
Estate Planning/Death Related Taxes
Exempt Organizations
Legislation and Regulations
Tax Audits and Litigation

December 20, 1988

**Comments by the
Section of Taxation of the District of Columbia Bar
on the House Ways and Means Oversight
Subcommittee Draft Report Describing Recommendations
on the Unrelated Business Income Tax**

The views expressed herein have been approved by both the Steering Committee and Tax Policy Committee of the Section of Taxation of the District of Columbia Bar, which Section has approximately 1,200 members. The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Tax Policy Committee is co-chaired by Donald C. Lubick and Roderick A. DeArment, and its members are: Jane C. Bergner, Collette C. Goodman, Ellen A. Hennessy, Gerald A. Kafka, Stephen A. Nauheim, Celia Roady, Bradley M. Seltzer, Marian S. Block, James A. Bruton, Carolyn Chiechi, Leonard J. Henzke, Jr., George P. Levendis, Patricia G. Lewis, Pamela F. Olson, Pennie E. Pirsch, Joseph A. Rieser, Jr., Lawrence J. Ross and Reeves C. Westbrook. The comments were initially prepared by and reflect the individual views of the UBIT Task Force of the Section's Exempt Organization's Committee. The following are the members of the UBIT Task Force: James M. Goldberg, Barry Hart, Leonard J. Henzke, Jr., Frances R. Hill, Robert J. Jones, Barbara Kirschten, Celia Roady, Stacey R. Silverman, and Jean Wright.

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COMMENTS OF THE
TAXATION SECTION OF THE DISTRICT OF COLUMBIA BAR
ON THE DRAFT REPORT OF THE
HOUSE WAYS & MEANS OVERSIGHT SUBCOMMITTEE
DESCRIBING RECOMMENDATIONS
ON THE UNRELATED BUSINESS INCOME TAX

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December 20, 1988

Comments by the Section of Taxation of
the District of Columbia Bar
on the Draft Report of the
House Ways & Means Oversight Subcommittee
Describing Recommendations
on the Unrelated Business Income Tax

The Section of Taxation of the District of Columbia Bar submits the following comments on the House Ways & Means Oversight Subcommittee Draft Report Describing Recommendations on the Unrelated Business Tax (UBIT) (the "Draft Report").[1/] The comments have been approved by both the Section of Taxation's Steering Committee and its Tax Policy Committee.[2/] They were initially prepared by and reflect the individual views of the members of the UBIT Task Force of the Section's Exempt Organizations Committee.[3/] It is hoped that these comments will be helpful to

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1/ The views expressed herein represent only those of the Taxation Section of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,200 members.

2/ The Tax Policy Committee is co-chaired by Donald C. Lubick and Roderick A. DeArment, and its members are: Jane C. Bergner, Collette C. Goodman, Ellen A. Hennessy, Gerald A. Kafka, Stephen A. Nauheim, Celia Roady, Bradley M. Seltzer, Marian S. Block, James A. Bruton, Carolyn Chiechi, Leonard J. Henzke, Jr., George P. Levendis, Patricia G. Lewis, Pamela F. Olson, Pennie E. Pirsch, Joseph A. Rieser, Jr., Lawrence J. Ross and Reeves C. Westbrook.

3/ These members include: James M. Goldberg, Barry Hart, Leonard J. Henzke, Jr., Frances R. Hill, Robert J. Jones, Barbara Kirschten, Celia Roady, Stacey R. Silverman, and Jean Wright.

It should be noted that while members of the Section's Steering and Tax Policy Committees and UBIT Task Force are private practitioners with client concerns, we have analyzed the Draft Report from the viewpoint of consistent tax policy and not individual interests.

reaching and unintended effects. We agree with the Treasury Department's position (expressed in Secretary Chapoton's testimony during the June, 1987 UBIT hearings) that additional information is needed concerning the extent of activities which allegedly misuse licensing agreements to avoid tax liability on pursuits which the UBIT is intended to reach.[5]

B. Royalties Measured by Net or Taxable Income Derived from the Property

Absent additional evidence as to whether extensive changes to the royalty exclusion are warranted, the royalty exclusion should basically be retained in its current form with certain targeted changes to ensure that the exclusion is limited to passive income. In those cases where a royalty arrangement does not constitute a truly passive activity, the UBIT should apply. We agree that where an exempt organization receives royalty payments representing a share of the net profits of a business, the role of the exempt organization " . . . is more akin to a partner in an active business than to a passive investor."[6] Therefore, we believe that the exclusion should not apply where a royalty is measured by net or taxable income derived from the licensed property. However, we believe that where a royalty arrangement does

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[5] Statement of O. Donaldson Chapoton, [then] Deputy Assistant Treasury Secretary for Tax Policy before the House Ways & Means Oversight Subcommittee (June 22, 1987) ("Treasury Department Statement").

[6] Id.

there is no justification for having a per se rule for property created or marketed by exempt licensors; such a rule unreasonably limits non-abusive situations.

We do believe, however, that the UBIT should apply where a tax-exempt organization plays a substantial role in the marketing of property which produces royalty income. Therefore, we recommend that the royalty proposal be modified to apply the UBIT to situations where the exempt organization created property and performed substantial services or incurred substantial costs with respect to the marketing of such property.

We are also concerned with the exception to the proposed "created or actively marketed property" rule regarding products "that further the organization's exempt function." This recommendation is confusing because it appears to require the exempt organization to meet the "substantially-related" test in order to fall within this exception. Under the current "substantially-related" test, the UBIT does not apply to income derived from activities and products which are substantially related to an organization's exempt purpose (even where the organization is actively engaged in the marketing or sales of such products). Code Section 513(a); Treas. Reg. § 1.513-1(d). Accordingly, in instances where the "substantially-related" test is met, the royalty exception does not even come into play. These two exceptions to the UBIT should continue to be distinct from each other; provided that one of these exceptions is met, there is no need to

the activity or whether or not the activity is substantially related to the organization's exempt purpose. Similarly, there is no reason to create a per se rule which distinguishes affinity merchandising activities from "cause-related fundraising" (where a business voluntarily makes contributions to a charity based on the sales of its services or products) simply because, in the case of an affinity merchandising activity, the charity may have entered into a contractual arrangement with such business under which the business is permitted to use the charity's name or logo.

Like the proposals discussed above, income derived from affinity credit card programs and other affinity merchandising activities should not be subject to the UBIT where the exempt organization is not actively engaged in or does not provide substantial services with regard to the affinity activity. For example, there is no reason to apply the UBIT to affinity activities unless the use of the exempt organization's name, logo, goodwill or other intangible asset rises to the level of an unrelated trade or business described in the examples in Treas. Reg. § 1.513-1(d)(4) (such as where a research organization regularly sells endorsements of various items of laboratory equipment to more than one manufacturer).

However, we do believe that where an exempt organization provides its mailing list to a for-profit entity in connection with an affinity program, it is appropriate to require that separate allocations be made between income derived from the transfer

(2) The proposal recommending a per se application of the UBIT to royalties received from the use of property created or actively marketed by an exempt organization should not be adopted. Instead, the proposal should be modified to apply the UBIT to situations where an exempt organization creates property and performs substantial services or incurs substantial costs in marketing the property.

(3) There should not be a special per se rule for affinity activities. The UBIT should only apply where an exempt organization actively participates in an unrelated affinity arrangement or effectively sells its endorsement on a regular basis. However, consistent with legislative intent expressed in the current Code, the UBIT should apply to income derived from the transfer of an exempt organization's mailing list to a for-profit entity in connection with an affinity program.

II. ALLOCATION OF EXPENSES FOR DUAL USE FACILITIES

DRAFT REPORT RECOMMENDATION: In the case of a facility used for both tax-exempt and taxable activities, if the facility is used 25 percent or less of the time (measured by actual use of the facility and not total time it is available for use) for a taxable activity, then only marginal costs attributable to the taxable activity should be allocable to the taxable activity in computing net income therefrom. If the facility is used 26 to 75 percent of the time for a taxable activity, then a portion of all costs attributable to the facility (i.e., operating costs, straight-line depreciation, and general and administrative expenses) should be allocable to the taxable activity based on

the reasons noted below, we believe that the proposal in its present form is over-broad and adopts an approach that would significantly restrict the ability of exempt organizations to deduct appropriate expenses in arriving at their income subject to the UBIT.

B. Three-Tier Rule for Allocation of Expenses

The Draft Report proposes a three-tier approach to the allowance of expenses in the case of any "dual use facility". In order to avoid any implication that the proposed rules apply only to real property, the Draft Report states that "the term dual use facility includes other property (such as a computer) used for both exempt and taxable purposes." In the case of such facilities, different rules will apply depending upon the percentage of the time the particular facility is used for a taxable activity, with the percentage being determined on the basis of actual use of the facility and not the total time it is available for use.

If the facility is used 25 percent or less of the time for taxable activity, then only the "marginal costs" attributable to the taxable activity would be deductible in arriving at the unrelated business taxable income. According to the Draft Report, marginal costs would be limited to the incremental costs incurred solely because of carrying on the taxable activity, such as extra security or increased utility or cleaning costs. No

unrelated trade or business of an exempt organization." In that way, exempt organizations will be prevented from obtaining a competitive advantage over taxable entities in those cases where exempt and taxable organizations engage in the same type of activities. Under the draft recommendations, an exempt organization which has a "dual use facility" that is used 25 percent or less for an unrelated activity will be subject to the marginal cost rule, and as a result will be put at a competitive disadvantage. Such an organization will have a higher taxable income (and higher tax cost) per dollar of revenue than a taxable organization engaged in the same activities which is permitted to deduct all of its costs, including both marginal and allocable fixed costs.

There is a legitimate concern that exempt organizations are over-allocating fixed costs to unrelated business activities, thereby understating their true taxable income from those activities, but we suggest that the answer should be increased audit scrutiny of fixed-cost allocations rather than placing those exempt organizations who can least afford it at a competitive disadvantage. The Service has ample experience with such allocations in other areas, such as under Section 482 of the Code. If it is felt that there is a need for a more easily administrable -- and thus more easily "auditable" -- system, this could be achieved by adopting a uniform, objective standard for allocating fixed costs, e.g., the allocation formula based on actual use which is proposed for the "second tier" in the Draft Report.

D. Less Drastic Changes Are Sufficient

We believe that the Subcommittee's concerns regarding tax avoidance can be resolved through a less drastic and more advantageous change in the allocation rules. We believe there is merit in having simpler and more objective rules, and suggest requiring most exempt organizations to use the actual time of use allocation formula which the Service prefers. To deal with unusual situations, we recommend that exempt organizations be allowed to obtain the advance written consent of the Service to use any other allocation method which reasonably reflects the appropriate allocation of expenses.

E. D.C. Bar Section of Taxation Recommendations

(1) The three-tier system should not be adopted. Instead, if an objective standard is required, the following approach could be applied to all exempt organizations: in the case of a dual use facility, revenues from the unrelated business use may be offset by the sum of (a) the marginal costs of that unrelated activity and (b) a portion of the fixed costs (i.e., those costs other than the marginal costs of the related and unrelated uses) based on the percentage of actual use of the facility for the unrelated activity compared to total actual use for all purposes. This approach more accurately reflects the true cost of using a

art work and preparation and printing of advertising copy, and allocable amounts of mechanical and distribution costs, salaries, rent, depreciation, and general and administrative costs. On the other hand, the following would not be deductible against net advertising income: fees paid to authors of articles, art work and printing costs for editorial content, and amounts of mechanical and distribution costs, salaries, rent, depreciation, and general and administrative costs allocable to editorial content.

B. Allowance of Fixed Costs

We believe that the approach suggested in the Draft Report is conceptually sound as long as the rules are administered in a manner that allows exempt organizations to deduct an appropriately allocable part of fixed costs in computing advertising income subject to the UBIT. As noted above in regard to the general allocation of expenses, the rules should not limit exempt organizations to deductions for marginal costs since that would put them at a competitive disadvantage vis-a-vis taxable organizations engaged in similar activities. Thus, similar to our general allocation recommendation, we recommend that exempt organizations be allowed to deduct the marginal costs associated with advertising activities plus an allocable portion of fixed costs.

C. D.C. Bar Section of Taxation Recommendation

When computing net advertising income, an exempt organization should be entitled to deduct (1) the

necessary to increase the deduction to compensate for inflation. Given the rationale for the specific deduction, we see no basis for distinguishing among organizations based on the subsection under which they are exempt. Whatever changes are made to the specific deduction should apply across-the-board to all 501(c) organizations.

B. Increase Deduction to $10,000

Today there are over 850,000 tax-exempt organizations of all types, not including the thousands of churches and thousands of local units included in group rulings. Many of these organizations are very small, staffed wholly by volunteers, and often managed by constantly changing boards of directors. These organizations must file a Form 990-T if they have gross unrelated business income of $1,000 or more.

The burden for these organizations is not so much the tax, but the disproportionate cost of the legal and accounting help necessary to comply with the UBIT complexities. This burden is exacerbated where there is only a small amount of UBIT. Judging from the UBIT proposals in the Draft Report, that compliance cost will be increasing. It would be a welcome and much desired relief for the small organizations if the specific deduction, and the minimum 990-T filing limits, could be raised in excess of the inflation adjustment -- perhaps to $10,000. In fact, Assistant Treasury Secretary Chapoton specifically stated in his testimony of May 9, 1988, that Treasury would have no objection to a

C. Indexing of Deduction

Congress has already recognized the need to index exemption amounts to inflation, and in 1986 it raised and indexed the personal exemption to the CPI Index. We propose the same approach with respect to the specific deduction. This approach will preclude the need for Congress to frequently adjust the deduction amount through specific legislation.

D. No Limitation on Application of Increased Deduction Amount

We also believe there is no sound reason for limiting the specific deduction amount to activities directly carried on by an exempt organization, as contrasted with income carried on by, for example, a partnership of which the organization is a partner. The rationale for the specific deduction is the same whether an organization has $10,000 of directly-carried-on or passive-type income.

If the increased deduction amount is limited to "directly-carried-on" income, the Service will find itself in the untenable position of collecting tax from an exempt organization which has $1,000 of "directly-carried-on" income, and $1,000 of partnership income, but not taxing the exempt organization which has $5,000 of "directly-carried-on" income. Moreover, the active-passive rule would insert a novel and complex new rule into a deduction which is designed to be simple and easily understood. The across-the-board specific deduction is now easily understood by laymen, and should remain so to accomplish its purpose.

other payments must disclose that a charitable deduction is allowable only to the extent that the amount of the payment exceeds the fair market value of the benefits received. Alternatively, the Committee should consider directing the Treasury Department to issue appropriate regulations in this area.

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A. Section of Taxation Overview

Since 1967, with the promulgation of Rev. Rul. 67-246, 1967-2 C.B. 104, the Service has taken the position that no deduction under Section 170 may be claimed for that portion of a charitable contribution representing the fair market value of goods or services received. The Draft Report builds on Rev. Rul. 67-246 and recommends that charitable organizations be required to disclose the extent to which charitable contributions are deductible when benefits are received. The Service has already taken steps in this direction, and on August 4, 1988, it announced that it is sending copies of Publication 1391, "Deductibility of Payments Made to Charities Conducting Fund Raising Events," to some 400,000 charities so that they may more accurately advise their contributors as to the deductibility of their contributions.[13] We believe that a requirement of this type should be imposed by either statute or regulation. However, it should be fashioned so as to make sure donors are aware of the limits on deductibility, while not imposing undue costs or recordkeeping requirements on exempt organizations.

13/ IR-88-120.

This modification has the added benefit of reducing the undue administrative burden which will fall upon charitable organizations if they are forced to value each and every item received by a donor.

Similarly, steps should be taken to insure that exempt organizations are not shouldering an undue portion of the costs of valuing property received by a donor. We agree that in some cases a charitable organization is better able to ascertain the value of such property. However, where the property is <u>donated</u> to a charitable organization, such as for sale in a school auction, the charitable organization may not know the fair market value of the donated property. Moreover, it would be unreasonable to expect a school to appraise hundreds of items.

We recommend that a special exception be enacted for property donated to charitable auctions. We also recommend that a similar exception be enacted for donated property outside of the auction context where the donated property has no commercial counterpart. Neither exception would affect the current rule disallowing a deduction for that portion of a "contribution" representing value received. The exceptions would merely ease the valuation burden on exempt organizations which will be paying the price, through increased administrative costs, for individual taxpayers' wrongful actions.

A. Section of Taxation Overview

The Draft Report recommends that the activities of an exempt organization's 80-percent owned subsidiaries be aggregated with the activities of the exempt parent for purposes of determining whether the parent is "primarily" operated for exempt purposes. If an organization is not operated primarily for exempt purposes, it loses its exemption.

The Draft Report outlines two perceived abuses that the aggregation rule is attempting to address: 1) unfair competition by businesses capitalized with tax-favored monies; and 2) the impropriety of charities spending large amounts of their time running for-profit businesses. Unlike other proposals, this recommendation is not directed to the mere taxation of unrelated business income, but, rather to the exemption of the organization itself. Thus, any changes in existing law should be specifically tailored to identifiable abuses. Otherwise, Congress may unwittingly deny tax-exemption to legitimate nonprofit organizations.

The Draft Report's recommendation to aggregate the activities of a subsidiary with those of a parent owning at least 80% of such subsidiary's stock improperly uses ownership as a rationale for attribution. For example, a parent could own 80 percent of the total value of a subsidiary's outstanding stock but not own a majority of the voting rights and, therefore, not control the subsidiary. Furthermore, even where an exempt parent owns 80 percent of the voting stock, it may not be involved in its

appropriate flexibility for exempt organizations. This approach allows special abuses to be contained without circumscribing the structural and operational flexibility offered by multi-entity structures.

In contrast, utilizing an arbitrary percentage level at which parent and subsidiary activity is aggregated for purposes of evaluating a parent's exempt status (such as the 80-percent test proposed in the Draft Report) is potentially both under-inclusive of abuses -- an organization may avoid coverage by having only 79 percent control -- overinclusive of abuses, i.e., ownership by itself is not the equivalent of having an exempt parent spend a significant amount of time or money controlling the day-to-day activities of a subsidiary. The Moline Properties rule, by contrast, focuses on cases in which a subsidiary is not really a separate business. It is in those instances that a parent is likely to devote a large amount of its resources to the subsidiary, and it is those cases to which the Service's resources should be targeted.

C. Alternative Proposal if Congress Adopts an Aggregation Rule

If Congress chooses to adopt some arbitrary percentage level of affiliation at which activities of a subsidiary will be attributed to its exempt parent, we believe the inherently uncertain case-by-case approach to primary purpose determinations should be supplemented with a safe harbor based on a parent's annual investment in its taxable subsidiaries. If a parent's annual

VII. DEFINITION OF CONTROLLED SUBSIDIARY FOR UBIT PURPOSES

DRAFT REPORT RECOMMENDATION: The definition of a "controlled organization" should be modified to mean, for certain UBIT purposes, an organization in which the parent tax-exempt organization owns (directly or by attribution) more than a 50 percent interest in the subsidiary organization, measured by either voting power or value. In addition, an organization should be considered to be a controlled organization for certain UBIT purposes if two or more tax-exempt organizations acting together own collectively more than a 50-percent interest in the subsidiary organization.

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A. Section of Taxation Overview

This draft recommendation addresses the receipt of interest, annuities, royalties, and rental payments from a controlled subsidiary to an exempt parent. Generally, the receipt of such items is only subject to the UBIT if received from a controlled subsidiary. For these purposes, control is currently defined as 80 percent of each class of voting and non-voting stock, without any attribution rule. The Draft Report expresses the concern that an exempt parent can avoid control for UBIT purposes while retaining control over the operations and value of the taxable subsidiary. For example, an exempt parent can avoid control by arranging for another shareholder, including another exempt organization, to hold 21 percent of a non-voting class of stock.

B. Recommendation Addresses Abuse

In contrast to the Draft Report's proposed aggregation rule discussed earlier, the proposed change in the definition of control for UBIT purposes specifically addresses an abuse of the current system. Ease of avoiding the control rule has led to the

very least, exempt arrangements entered into under a binding contract before enactment of any new provisions. This will allow exempt organizations to comply with such provisions in a timely manner and adjust their financial plans and fundraising efforts accordingly. In either case, only prospective effective dates should apply.