Unrelated Business Income
IRS New Emphasis

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I. INTRODUCTION

Even though a nonprofit may be “tax exempt,” section 501 of the U.S. Internal Revenue Code (“Code”), its income is nonetheless subject to federal income taxation at corporate rates to the extent the income is classified as unrelated business taxable income (UBIT).1 State colleges and universities (and any corporation owned by one or more such colleges or universities) are also subject to taxation of UBIT.2

II. GENERAL RULE

Subject to special rules, UBIT means the gross income (less directly connected expenses) derived from any (A) unrelated (B) trade or business (C) regularly carried on.3

A. Relatedness Test. An “unrelated” trade or business is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of the purpose or function constituting the basis for its exemption.4

1. An activity that is a trade or business, is “related” to the exempt purpose of the organization if the activity is causally related to the achievement of the organization’s exempt purpose and the causal relationship must substantial “contribute importantly” to the exempt purpose.5 If the activity is carried on more extensively than necessary, income from the excess activity6 is treated as unrelated. See Req. §1.513-1(d)(3).

2. The United States Supreme Court has dealt with “relatedness” in the “conduct” of an activity (the sale of advertisements in the organization’s medical journal). There the organization argued that the advertisements were “educational” to its membership, but the Court found that the commercial and nonselective manner in which the organization conducted the sale of advertising established that the activity was not in furtherance of educational purposes.6

3. Current matters of interest.

   a. Museums.7

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1 Code Sec. 511.
2 Id.
3 Code Sec. 512(a).
4 Code Sec. 513(a). In the case of state colleges and universities, the key issue is any purpose or function described in Section 501(c)(3).
5 Reg. § 1.513-1(d)(2).
7 Tech. Adv. Mem. 9550003 (September 18, 1995) held the following to be related (non-taxable): books, tapes, records, films and compact discs on period topics and on restoration and collection activities undertaken by the museum; toys, games, hats and flags; non-prepackaged food products; reproductions and adaptations of prototypes in the museum’s collection; contemporary products, such as films, batteries, flashbulbs, ponchos and umbrellas sold for the convenience of visitors; some cards, ornaments and decorations; and note cards, calendars and postcards imprinted with representations museum art work. Unrelated (taxable) sales include miscellaneous contemporary products such as newspapers, magazines, cigarettes and candy; prepackaged foods, toiletries and tobacco products; souvenirs and mementos; ornaments and decorations that are not part of the museum’s collection; products that are interpretations of or
b. Travel programs.\textsuperscript{8}

c. Universities\textsuperscript{9}

have designs taken from the historical period depicted by the museum other than reproductions or adaptations; and blank books, napkins, paper plates, stationery and address books. Off-site and on-site sales are the same, Rev. Rul. 73-104, 1973-1 C.B. 263, but engraving done on-site (with onlookers and using historical-period methods) is not UBIT whereas off-site engraving and gift-wrapping is UBIT.

In Tech. Adv. Mem. 9702003 (August 28, 1996) the IRS found insubstantial relationship to exempt purpose where a museum rented its facilities to corporate and business patrons for special events usually, but not always, held in connection with special events after the facility was closed to the general public. The food and related set-up and services were catered, but the museum purchased liquor (it had the license), provided union personnel for setting up and operating equipment, and provided guided docent tours. The IRS found the educational aspects “ancillary to the events’ principal purpose of permitting outsiders to utilize [the] facilities during off hours for business and social gatherings.” The services also took the income out of the rent exclusion discussed below. But see Madden et al. v. Commissioner, T.C. Memo. 1997-395.

\textsuperscript{8} Regulations on travel and tour activities (Under Reg. § 1.513-7) were issued by the IRS on February 4, 2000. The regulation contains only a brief statement of the UBIT general rule and four examples.

\textbf{Example 1} UBIT from an alumni association program open to its members and their guests and arranged by a travel agency which pays a per-person fee to the association; although a faculty member is present, none of the tours includes any scheduled instruction or curriculum related to the destinations being visited.

\textbf{Example 2} No UBIT where there is a “substantial amount of required study in a program sponsored by an organization whose purpose is education about the geography and culture of the U.S. consisting of tours of parks and other locations in the U.S. conducted by education professionals and participants agree to participate in the required study program including; five or six hours per day are devoted to study, with a library, exams, and state board of education academic credit.

\textbf{Example 3} No UBIT where a Section 501(c)(4) social welfare organization devoted to advocacy on a particular issue organizes a profitable tour to Washington, D.C.; while in Washington, the members follow a schedule pursuant to which they spend substantially all of their time attending meetings with legislators and government officials and received policy briefings.

\textbf{Example 4} An example “fragmentation” rule. This example involves an organization whose membership is open to all Americans interested in the “X” heritage and that fosters cultural unity and educates Americans of that heritage about their country of origin. The IRS found no UBIT where the trips to X were “designed” to immerse participants in the X history, culture unity and educates Americans of that heritage about their country of origin. No UBIT from category “A” tours where trips to X were “designed” to immerse participants in the X history, culture, and language and the itineraries was “designed” to have participants spend “substantially all of their time while in X” receiving instruction with destinations selected because of their historical or cultural significance or because of instructional resources they offer. But the IRS found UBIT from category “B” tours where, rather than offering scheduled instructions, participants are given the option of taking guided tours of various X locations, but there is no instruction or curriculum other than the optional tours; and even if they take all of the optional tours offered, participants have a “substantial” amount of time to pursue their own interests at destinations of “principally” recreational interest.

\textsuperscript{9} In Tec. Adv. Mem 9645004 (July 17, 1996) the IRS concluded that the alumni use of a university’s golf course does not contribute importantly to the accomplishment of the University’s exempt purposes. The IRS rejected the argument that making available a golf course the university is provided an “inducement” for alumni to make financial contributions or otherwise engaged in the University. This conclusion is consistent with Prvt. Ltr. Rul. 8020010 but contrasts with Prvt. Ltr. Rul. 8340101. See also Oakland Univ. v. Commissioner, Tax Ct. Dkt. No. 2570-97.

IRS rulings involving insurance programs often cite United States v. American Bar Endowment, 477 U.S. 1986), as an example of an exempt organization’s extensive involvement in the administration of an insurance program. That case, however, is more narrowly focused. The United States Supreme Court addressed only whether the activity was a “trade or business” under
d. Alumni use of university facilities, e.g., golf courses.

e. Insurance programs as a related activity.\(^{10}\)

f. Associate or “Split Member” Dues.\(^{11}\)

g. Sale of standard forms; lawyer referral services.\(^{12}\)

h. Health and Fitness Clubs.\(^{13}\)

i. Management and Research Services.\(^{14}\)

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the basic three-part test for UBIT discussed above.

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Any review of insurance programs should consider Code Sec. 501(m), which provides that Section 501(c)(3) and (4) organizations risk loss of exempt status if a substantial part of its activities consists of providing “commercial-type insurance.” The statute does not define “commercial-type insurance,” (H.R. Rep. No. 426, 99th Cong., 1st Sess. 665 (1985) suggests that commercial type insurance generally is of a type provided by a commercial insurance company) but does tell us that such insurance does not include insurance provided at substantially below cost to a class of charitable recipients; The new healthcare legislation could have some application to insurance companies and self insured employers through a new tax on their gross premium revenues.

\(^{11}\) The IRS position is that dues from “associate” members are UBIT where such members are eligible to participate in an insurance program but do not otherwise have full membership provisions. The Service’s position was upheld with respect to Section 501(c)(5) labor, agricultural and horticultural) organizations in American Postal Workers Union v. United States, 925 F.2d 480 (D.C. Cir. 1991); National Association of Postal Supervisors v. United States 944 F.2d 859 (Fed. Cir. 1991); and National League of Postmasters of the United States v. Commissioner of Internal Revenue, T.C. Memo. 1995-205, affirmed, 86 F.3d 59 (4th Cir. 1996).

\(^{12}\) See Tech. Adv. Mem. 9527001 (January 30, 1995) (the IRS found UBIT from the sale of standard forms sold by a local chapter of a national professional association, concluding that the forms helped members in their individual capacities rather than as members of a profession); but compare Pvt. Ltr. Rul. 9645027 (the IRS found no UBIT arising out of a 501(c)(6) bar association's lawyer referral service, since this promoted the common business and professional interests of members and provided a local community benefit).


\(^{14}\) In B.S.W. Group v. CIR, 70 T.C. 352 (1978) the Tax Court held that the consulting services provided to exempt organizations went beyond education and into participation into the direct management of the organizations and hence were a commercial business. See also Rev. Rul. 72-369, 1972-2 C.B. 245 (providing managerial and consulting services to client organizations was not an exempt activity) and GCM 39622 (December 15, 1986) (day care provider had UBIT from designing and operating dependent care plans for individual employers). But compare TAM 9847002 and PLR 9849027 where the IRS ruled that there was no UBIT even though administrative or management services are being provided, and see the same results in PLRs 199924065, 9814038 and 9819049 in the context of joint operating agreements where something similar to a parent-subsidiary relationship exists. Recently the IRS ruled in PLR 199945062 that a library did not receive UBIT when it charged a fee to provide information and advice (only) through an “interactive virtual library” which (on a basis which will “not be expensive”) allows the library reference staff to help remote users identify and use information sources and educate them on how to apply information in answering users’ specific questions about use of the library’s extensive business-related materials).
j. Exclusivity Arrangements.

k. Internet Issues\textsuperscript{15}

B. Trade or Business Test. A “trade or business” includes any activity carried on for the production of income from the sale of goods or the performance of services, such an activity does not lose its identity 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. See Code Sec. 593©; Reg. §1.513-1(b).

1. Profit Motive. Although the statute does not make the presence or absence of profits a factor in determining the existence of a trade or business, several federal Circuit Courts of Appeal have adopted the test that a trade or business exists if the activity was entered into “realize a profit.”\textsuperscript{16}

2. Competition. Although an important purpose of adopting the UBIT rules in 1950 was to eliminate “unfair” competition perceived to exist when nonprofits engaged in commercial endeavors, the case law seems not to require an actual showing of competitive effect when judging whether the UBIT rules should apply to a particular activity.\textsuperscript{17}

3. Passivity. The courts appear to recognize that merely passive activities do not constitute a “trade or business.” For example, investing, is not normally a trade or business, nor apparently is a covenant not to compete.\textsuperscript{18}

4. Analogous Exemption Factors. It is sometimes hard to distinguish between tests for UBIT and tests for compliance with the requirement that an exempt organization must “operate” for its exempt purposes.

\textsuperscript{15} See Rev. Rul. 2004-112, I.R.B. 985. There the IRS discussed a website created by a 501(c)(6) trade association for its members that contained a supplementary information on the shares. That was considered related to the tax exempt function of the trade association. The website was also used by the public for a 2 week period listing products and services that was not educational but rather the promotion of business and advertising that is an unrelated business.

\textsuperscript{16} United States v. American Bar Endowment, 477 U.S. 105, at 110 n. 1 (1986); American Postal Workers Union v. United States of America, 925 F.2d 480 (D.C. Cir. 1991); Fraternal Order of Police v. Commissioner, 87 T.C. 747, aff’d, 833 F.2d 717 (7th Cir. 1987); Louisiana Credit Union League of the United States, 693 F.2d 525 (5th Cir. 1982); Carolinas Farm & Power Equipment Dealers v. United States, 699 F.2d 167, 169 (4th Cir. 1983); Professional Insurance Agents of Michigan v. Commissioner, 726 F.2d 1097, 1102 (6th Cir. 1984). See Tech. Adv. Mem. 9636001 (January 4, 1995) (extensive publishing activities of a Christian educational organization deemed larger than necessary to accomplish the organization’s exempt functions); but compare American Academy of Family Physicians, No. 95-2791WM (8th Cir. 1996) (in addition to the profit motive requirement, there must also exist “the general characteristics of a trade or business,” noting that some courts have required a showing of “extensive business activities”).

\textsuperscript{17} American Bar Endowment, supra (Stevens, J., dissenting on the basis that no competitive effect had been demonstrated). However recent lower court decisions have raised the issue of commercialism in the context of competition with profit for business.

\textsuperscript{18} With respect to passive investment activities, see San Antonio District Dental Society v. United States, 340 F. Supp. 11 (W.D. Tex. 1972) where receipts from payment plan to finance dental care were net income form a trade of business where dental society lacked any control over the possible financial results from independent bank’s efforts. See Ohio Farm Bureau Federation, 106 T.C. No. 11 (1996), where the Tax Court determined that signing a one-time agreement not to compete does not constitute the kind of continuous and regular activity that is characteristic of a trade or business.
a. Facts and Circumstances. Determining the existence or absence of a commercial purpose in exemption cases is a “facts and circumstances” determination in the view of the Tax Court.\footnote{See United Missionary Aviation, Inc. v. Commissioner, T.C. Mem. 1990-566 (October 19, 1990), where the court considered the manner in which the activity was conducted, competition with commercial firms, whether materials were provided below cost to nonprofits and the existence of substantial profits.}

b. Accumulation of Profits. The accumulation of profits is a factor, but the reason for accumulation is important.\footnote{See Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984) (accumulation for plant expansion after notice to IRS did not cause loss of exempt status); Scripture Press Foundation v. United States, 285 F.2d 800 (Ct. Cl. 1961), cert. den., 368 U.S. 985 (1962) (large accumulation of profits which remained unexpended showed that the corporation operated as a publishing business rather than a religious organization).}

c. Commercialism; Efficiency. The appearance of “commercialism” is also important to the courts.\footnote{See American Institute for Economic Research v. United States, 302 F.2d 934, 938, at n. 114 (ct. Cl. 1962); see Estate of Hawaii v. Commissioner, 71 T.C. 1067 (1979), aff’d, 647 F.2d 170 (9th Cir. 1981) (program “part of a franchise system which is operated for private benefit and…its affiliation with this system taints it with a substantial commercial purpose”); The Incorporated Trustees of the Gospel Worker Society of the United States, 510 F. Supp. 374, 381 (D.D.C.), aff’d, 672 F.2d 894 (D.C. Cir. 1981), cert. den., 456 U.S. 44 (1982) (publishing activities took on a “commercial hue” and had become a “highly efficient business venture”); cf. Presbyterian and Reformed Publishing Co. v. Commissioner, supra, see Tech. Adv. Mem. 9719002 (loss on food business provided as an accommodation to buyer of a building was not from a trade or business).}

C. “Regularly Carried On” Test. Whether a trade or business is “regularly carried on” is determined by reference to the “frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued…in light of the purpose…to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete.”\footnote{Reg. § 1.513-1(c)(1).}

1. An activity during two weeks of an annual state fair is not “regularly carried on,” but an activity on every Saturday of the year is.\footnote{Reg. § 1.513-1(c)(2)(i).}

2. Although the IRS disagrees with the result, a court concluded that advertising in programs for the three-week NCAA basketball tournament did not produce income from an activity “regularly carried on” and that the year-round sales of advertising were merely in the nature of “preparation time.”\footnote{National Collegiate Athletic Association v. Commissioner, 914 F.2d 1417 (10th Cir. 1990), nonacq. recommended, AOD 191-015. March 22, 1984) to the seemingly contrary result in Suffolk County Patrolmen’s Benevolent Association v. Commissioner, 77 T.C. 1314 (1981), the IRS distinguishes that case because it involved preparatory time of only 8-16 weeks before each performance.}

3. The activities of those acting on the organization’s behalf can be attributed to the organization on an “agency” theory.\footnote{State Police Association of Massachusetts v. Commissioner, T.C. Memo. 1996-407 (September 4, 1996), aff’d No. 97-1319 (1st Cir. 1997), found a “regularly carried on” trade or business where the State Police Association hired an independent company to solicit advertising in its once-a-year Constabulary publication during normal business hours for about 46 weeks a year; the Constabulary was not sold, but rather distributed free at the state annual picnic (400 copies), to trooper barracks (about 1,000 copies), and to businesses.}
III. SPECIAL RULES.

A. Donated Work or Merchandise; Convenience Rules. UBIT does not include income from any trade or business in which substantially all the work is either performed without compensation,26 or which is the selling of merchandise, or substantially all of which has been received as gifts or contributions; or which is carried on, in the case of Section 501(c)(3)27 organization or a state college or university, primarily for the convenience of members, students, patients, officers or employees.28

B. Dividends. Except in the case of debt-financed income (discussed below), dividends (and directly related expenses) are excluded in the calculation of UBIT.29

C. Interest. Is not subject to UBIT, except in the case of debt-financed income and receipts from controlled organizations. Interest and directly related expense are excluded from the calculation of UBIT.30

D. Rents. Are generally not subject to UBIT, except in the case of debt-financed income and receipts from controlled organizations, rents from real property and incidental rents from personal property leased with real property are also excluded in the computation of UBIT. Rents from personal property are “incidental” only if they do not exceed 10 percent of the total rents from all the property leased. However, if rents from personal property exceed 50 percent of the total rents, all rents (including the rent from real property) are UBIT. Also, the rents are UBIT if the determination depends in whole or in part on the income or profits derived from the property leased (other than an amount based on a fixed percentage of receipts or sales).31

1. “Real Property.” The first obvious but often overlooked question is whether the rent is from passive rental activities without the provision of substantial services rendered to occupants. Parking lot revenues, for instance, are regarded by the IRS as income from a license and/or the performance of

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26 “Substantially all” has not been defined by the IRS except in limited situations.” In Priv. Ltr. Rul. 9544029 (August 5, 1995) the IRS concluded that the test was met where a religious organization used volunteers supervised by paid staff in a ratio of 10 to 1 to sell wearing apparel and other items including crosses, buttons, key chains, flags and bumper stickers containing inscriptions or artwork with a Biblical message or theme. The courts have been more helpful. See Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner, 42 T.C.M. 1202 (1981), aff’d in part and rev’d in part, 696 F.2d 372 (9th Cir. 1982) (bingo taxable when bartender and caller constituted 23.1% of the total man-hours); St. Joseph Farms of Indiana Brothers of the Congregation of the Holy Cross v. Commissioner 95 T.C. 9 (1985) (test met where uncompensated workers constituted 91% of the farm labor force and 94% of the total hours worked on the farm); Greene Cty. Medical Society Foundation v. United States, 345 F. Supp. 900 (W.D. Mo. 1972) where the reimbursement of volunteer expenses is not considered compensation.

27 Primarily for the convenience of exception has been applied in the hospital setting for patients of the hospital receiving pathological and diagnostic services. See St. Lukes Hospital v. U.S., 494 F. Supp. 85 (1980)

28 Convenience rule applies to students for example on on-campus laundry and dry cleaning services for university students. Reg. § 513-1(e) and Rev. Rul. 55-67, 1955-2CB, 266.

29 Code Secs. 512(b)(1), 512(b)(4).

30 Code Secs. 512(b)(1), 512(b)(4).

31 Code Secs. 512(b)(3); Reg. § 1.512(b)(2). See Ltr. Rul. 9551019.
services unless the space is dedicated to a particular payor who is responsible for the property.\textsuperscript{32}

2. **Rent vs. Services.** The furnishing of heat and light, the cleaning of public entrances, exists, stairways, and lobbies, and the collection of trash are not considered services rendered to the occupant.\textsuperscript{33} But income from maid services to particular occupants would be considered income from services.\textsuperscript{34}

3. **Rents vs. License.** In Pvt. Ltr. Rul. 9740032 a charitable organization allowed a for-profit advertising agency to use a wall on the charity’s premises for advertising displays. The IRS ruled that that transaction was a license to occupy the premises, rather than a lease (which is characterized by a grant of possession of the premises), with the result that the income is not excluded from UBIT as rent. In TAM 9853001 the IRS advised that income from the storage of trailers, campers, motor homes, boats and cars in some of its building for a fee was UBIT.

4. **Title-Holding Companies.** Effective for tax years beginning on or after January 1, 1994, a Section 501(c)(2) and 501(c)(25) title-holding company may receive otherwise disqualifying UBIT of up to 10 percent of its gross income for the tax year, but only if the UBIT was “incidentally” (e.g., parking or vending machines) derived from the holding of real property (e.g., parking or vending machines); inadvertent violations of the 10 percent rule can be waived by the IRS.\textsuperscript{36} The IRS has published some guidance with respect to “qualified subsidiaries” of Section 501(c)(25) title-holding companies.

E. **Securities Loans and Notional Contracts.**

1. Except in the case of debt-financed income (discussed below), payments with respect to securities loans (as described in Section 512(a)(5)) and income from notional principal contracts (as defined in Reg. Sec. 1.863-7 or regulations issued under Section 446) are excluded in the calculation of UBIT.

2. See discussion below with respect to option premiums.

F. **Annuities.** Gift annuities are excluded from calculation of UBIT so long as the obligation to pay the annuity is one which (1) is the sole consideration (other than a mortgage to which Section 514(c)(2)(B) applies) issued in exchange for the property, if, at the time of the exchange, the value of the annuity is less than

\textsuperscript{32} Gen. Couns. Mem. 39825.

\textsuperscript{33} Reg. Sec. 1.512(b)-1(c)(5).

\textsuperscript{34} See LTR 9313010 (12/18/92) (dealing with the definition of “rents from real property” as the term applies to real estate investment trusts, but the terminology is the same and the analysis by the IRS refers to Code Sec. 512(b)(3)). In Tech. Adv. Mem. 9702003 (August 28, 1996) the IRS determined that a museum’s activities in renting its facilities to corporate and business patrons for special events was not sufficiently related to the museum’s educational purposes, and also found that the rent exclusion did not apply because the museum provided substantial services primarily for the convenience of the patrons (e.g., providing the patron organization with an estimate of its cost for the event, and providing personnel and liquor).

\textsuperscript{35} This modification of a hard-line IRS position that title-holding companies could have no UBIT was reversed by the Omnibus Reconciliation Act of 1993 (“OBRA”) Sec. 13146(a), adding Code Sec. 501(c)(25)(G) and OBRA Sec. 13146(b), amending Code Sec. 501(c)(2).

\textsuperscript{36} Id.
90 percent of the value of the property received in the exchange; (2) is payable over the life of one or two individuals in being at the time the annuity is issued; and (3) is payable under a contract which (a) does not guarantee a minimum amount of payments or specify a maximum amount of payments and (b) does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.37

G. Royalties. Royalties and all deductions connected with royalties are excluded from UBIT except in the case of debt-financed income and receipts from controlled organizations. Royalties (including overriding royalties) whether measured by production or by gross are excluded from UBIT.38 Generally, a royalty is defined by the courts as a payment for the use of a valuable right such as a trademark, trade name, service mark, or copyright, regardless of whether the property represented by the right is used.39 If a licensor retains quality control rights with respect to the licensed product it does not cause payments to the licensor to lose their character as royalties.40 The IRS has held that payments received for the personal endorsements by the organization’s members of products or services are payments for personal services and not royalties.41 Royalties may be received from books, plays, copyrights, trade names, patents and from the exploitation of natural resources.

H. Mailing and Membership Lists; Affinity Cards.

1. The IRS held for a number of years that the rental of mailing lists to organizations marketing their affinity cards to members was subject to UBIT. However after the loss of several court decisions,42 the IRS has apparently conceded the issue based in large part on the decision in Oregon State University Alumni Ass’n, Inc. where the court said that the organization’s activity in the program was insubstantial.

2. The IRS in Pvt. Ltr. 199938041 indicated a willingness to also accept, under certain circumstances, that marketing and licensing for its exempt parent, will not be attributed to the parent for purposes of determining the parent’s continued qualification for exempt status or liability for tax on unrelated business income.

I. Sales or Other Disposition of Property; Options; Forfeiture of Deposits; Short Sales. Except in the case of debt-financed property (discussed below), gains or losses from the sale, exchange, or other disposition of property are excluded in the computation of UBIT, except in the case of (1) inventory-type property,

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37 See Code Secs. 512(b)(1), 512(b)(4), 514(c)(5); Reg. § 1.512(b)-1(a)(1).
38 Code Sec. 512(b)(2); Reg. § 512(b)-1(b).
39 See National Well Water Ass’n, Inc. v. Commissioner, 92 T.C. 75 (1989); Commissioner v. Affiliated Enterprises, Inc., 123 F.2d 665 (10th Cir. 1941), cert. den. 315 U.S. 812 (1942); Commissioner v. Wodenhouse, 337 U.S. 369 (1949); Rohmer v. Commissioner, 153 F.2d 61 (2d Cir. 1946); Sabatini v. Commissioner, 98 F.2d 753 (2d Cir. 1938).
40 Lemp Brewing Co. v. Commissioner, 18 T.C. 586 (1952), acc. 1952-2 C.B. 2; Rev. Rul. 81-78, 1981-1 C.B. 135 (situation 1); LTR 9436001 (September 23, 1993).
42 Sierra Club, 103 T.C. Memo, 1993-199, aff’d, 86 F.3d 1526 (9th Cir. 1996); Common Cause, 112 T.C. No. 3 (1999); Planned Parenthood, Fed. of America, Inc., T.C. Memo. 1999-2006 (1999); Oregon State University Alumni Association, Inc., and Alumni Association of the University of Oregon, Inc., CA-9, 99-2 USTC Par. 50, 879, Mississippi State University Alumni Ass’n, Inc. v. Commissioner, T.C. Memo 1997-397.
(2) property held primarily for sale to customers in ordinary course of business, and (3) certain sales by social clubs.

1. There is an exception from UBIT for gains and losses from the sale, exchange or other disposition of certain real property and mortgages acquired from financial institutions that are in conservatorship or receivership.

2. There is no UBIT from gains or losses on the lapse or termination of options to buy or sell securities in connection with the organization’s investment activities or from gains or losses from options on real property or from the forfeiture of good-faith deposits (consistent with established business practices) for the purchase, sale, or lease of real property.

3. There is no UBIT from the short sale of stock through a broker.

J. Research. Income (and all related deductions) from research is excluded in the calculation of UBIT in the following situations:

   1. Income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any state or political subdivision thereof;
   2. In the case of a college, university or hospital, income derived from research performed for any person;
   3. In the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, all income derived from research for any person.

K. Unrelated Debt-Financed Income.

   1. The general rules excluding dividends, interest, royalties, rent and proceeds from dispositions of certain property do not apply if the income is from “debt-financed” property, i.e., property subject to “acquisition indebtedness.”
   2. “Acquisition indebtedness” generally means indebtedness that would not exist but for acquisition of the property in question.

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43 See generally Code Secs. 512(b)(5) (general rule), 512(a)(3) (special rule for social clubs described in Code Sec. 501(c)(7) and organizations described in Code Secs. 501(c)(9), (17), or (20)). See, e.g., Pvt. Ltr. Rul. 9619069 (February 13, 1996) (no UBIT where a tax-exempt organization whose purpose was the endowment of a school subdivided and sold unimproved farmland to unrelated third parties at fair market value); 9704010 (no UBIT where school participated directly or indirectly in partnerships created to finance infrastructure improvements and subdivide 159 acres into five to seven large parcels with the hope of selling large parcels to real estate developers); Pvt. Ltr. Rul. 9745025 (sale of an apartment building).

44 Code Sec. 512(b)(16).
45 Secs. 512(b)(1), 512(b)(5).
46 See Code sec. 512(b).
47 Code Sec. 512(b)(7).
48 Code Sec. 512(b)(8).
49 Code Sec. 512(b)(9).
50 Code Secs. 512(b)(c), 514.
51 Code Sec. 514(c). In Southwest Texas Electrical Cooperative, Inc. v. Commissioner of Internal Revenue, 67 F.3d 87 (5th Cir. 1995), the Fifth Circuit affirmed the Tax Court’s holding that
3. The amount of income reported as UBIT is generally determined by a ratio of the average amount of acquisition indebtedness during the taxable year to the property’s average adjusted basis (including straight-line depreciation) during such taxable year.\(^{52}\)

4. An important exemption from the debt-financed income rules is provided for certain indebtedness incurred in connection with the acquisition or improvement of real property by schools and their affiliated support foundations, pension plans, title-holding companies described in Code Sec. 501(c)(25) if a partnership all of whose partners are one of the foregoing or which meets rigid profit and loss allocation rules.\(^{53}\)

5. Property “substantially related” to the organization’s exempt purpose is not subject to the debt-financed property rules.

L. Partnerships; Limited Liability Companies and S Corporations.

1. Exempt organizations are permitted to be either general or limited partners in partnerships or members in a limited liability companies (LLCs).\(^{54}\)

2. If an exempt organization is a member of a partnership that regularly carries on a trade or business that is unrelated, it must include the unrelated taxable income of its partnership share and deductions directly connected with the included income. See §512(c)(1).\(^{55}\)

3. A nonprofit economic development organization may form a limited liability company for the purpose of lending money to businesses in an economically depressed region without jeopardizing its tax-exempt status or incurring unrelated business taxable income.\(^{56}\)

4. The IRS has since Plumstead required an exempt organization that participates in a general partnership require a showing that the exempt purposes of the organization are served and that its interests are properly protected through guarantees, indemnities and penalties that would prevent potential benefit to limited partners. Additionally, the IRS considers “control” of the substantive functions of the partnership to be an important factor where the exempt organization or its affiliate is a general partner.\(^{57}\)

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\(^{52}\) Code Sec. 514(a)(1); Reg. §§ 1.514(a)-1(a)(1), 1.514(a)-1(b)(2)(ii).

\(^{53}\) Code Sec. 512(c)(9), Treas. Reg. § 1.514(c)-2; see Pvt. Ltr. Rul. 95-10040.

\(^{54}\) Code Sec. 512(c)(1); see Reg. §1.512(c)-1 regarding income and expenses includable in UBIT.

\(^{55}\) Code Sec. 512(c)(1), as amended by P.L. 103-66, § 13145(a)(1)-(3).

\(^{56}\) See Pvt. Ltr. Rul. 9731038.

\(^{57}\) Rev. Rul. 98-15 (March 23, 1998) (the “hospital” joint venture ruling); Redlands Surgical Services v. Commissioner, 113 T.C. No. 3 (1999) (declaratory judgment for exempt status of the subsidiary of a parent of a typically reorganized hospital system in California). Cf. Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff’d, 675 F.2d 244 (9th Cir. 1982) (limited partners had no control over partnership of charitable general partner), Housing Pioneers v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff’d, 49 F.3d 1395 (9th Cir. 1995) (activities of co-general partner were so narrowly framed that for-profit partner was in a position of control with inappropriate private benefit). See St. David’s Health System v. U.S., 349 F.3d 232 (5th Cir. 2003); Pvt. Ltr Rule 200548026 and 200448048 (Control of partnership to own and operate an MRI facility).
5. **S Corporation Stock.** S corporation stock owned by a charity is treated as an interest in an unrelated trade or business, regardless of whether it is related or unrelated to the organization tax exempt purpose.\(^{58}\)

6. **Tax treatment of holding S corporation stock.** All dividend interest and other passive income received by an exempt organization that was passed through an S corporation are subject to UBIT.\(^{59}\)

7. An organization eligible to take advantage of the “check the box” regulations will be treated as an association (corporation) rather than a partnership if it has been determined or claims to be exempt from taxation under Section 501(a). Treas. Reg. §301.7701-3(c)(1)(v)(A).

**M. Trade Shows.**

1. Income from certain activities of state and other fairs or expositions promoting agricultural and educational activities conducted by Section 501(c)(3), (4) or (5) organizations, is excluded from UBIT.\(^{60}\)

2. Income from rental of display space, or refreshment at an industry-type trade show conducted by a Section 501(c)(3), (4), (5) or (6) organization, is excluded from UBIT, even if exhibitors are permitted to sell or solicit orders, so long as the purpose of the show is the education of members, or the promotion and stimulation of interest in, and demand for, the products or services of the industry and the show is designed to achieve that purpose through the exhibits or the character of the conferences and seminars held at a convention or meeting.\(^{61}\)

**N. Bingo and other Gambling.**

1. **Bingo Games.** Bingo games where wagers are placed, winners are named and prizes are distributed is excluded from UBIT so long as the conduct of the event is not carried on in a commercial basis and does not violate state law.\(^{62}\) “Pull tab” or types of “instant” bingo, even though legal under state law, is not exempt from UBIT.\(^{63}\)

2. In the absence of application of the above exemption, the only way a gambling event is excluded from UBIT is if substantially all the work is carried out by volunteers.\(^{64}\)

3. The IRS has conceded that contributions made by the exempt organization conduct a gambling activity are deductible as a Section 162 business expenses if the contribution is mandated by state law.\(^{65}\)

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\(^{58}\) Section 512(e)(1)(A).

\(^{59}\) Section 512(3)(1)(B).

\(^{60}\) Code Secs. 513(d)(1) and (2).

\(^{61}\) Code Secs. 513(d)(1) and (3), Reg. § 1.513-3.

\(^{62}\) Code Sec. 513(d); Reg. § 1.513-5; Tech. Dev. Mem. 9711003 (95% of income used for bingo, 3.5% for charitable activities).

\(^{63}\) Julius M. Israel Lodge of B’nai B’rith v. Comm., T.C. Memo. 1995-439, CCH Dec. 50,841 (M), RIA T.C. Memo ¶95, 439, aff’d, No. 96-60087 (5th Cir. 1996).

\(^{64}\) Code Sec. 513(a)(1); see Executive Network Club, Inc. V. Commissioner, T.C. Memo. 1995-21 (casino operated by tax-exempt organization failed to substantiate the “volunteer” nature of its activities because tips paid to workers constituted compensation).

\(^{65}\) See South End Italian Independent Club v. Comm’, 78 T.C. 168 (1986); Borenstein, “UBI
4. The IRS has ruled that proceeds from a raffle were not exempt function income to a tax-exempt political committee under Sec. 527. Bingo games and fund raising and entertainment events are treated as exempt function income if the events are political in nature and carried on in the ordinary course of a trade or business including dinners, breakfasts, picnics, etc. that are intended to really and encourage political support.

O. Certain Hospital Services.

1. Section 513(e) provides an exclusion from UBIT where a tax-exempt hospital provides services under the following circumstances: (1) such services are furnished solely to tax-exempt hospitals which have facilities to service not more than 100 inpatients; (2) such services, if performed on its own behalf by the recipient hospital, would constitute activities in fulfilling its tax-exempt purposes; and (3) such services are provided at cost (including straight-line depreciation and a reasonable return on capital goods used to provide such services).  

2. The operation of section 513(e) is limited to the services described in section 501(e) including most hospital services except laundry services which are excluded under section 501(e).

P. Certain Distribution of Low-Cost Articles.

1. Charitable organizations and veterans’ groups (that is, organizations described in Sections 501 and 170(c)(2) or (3)) are not required to report UBIT if the income results from activities relating to the distribution of “low cost” articles incidental to solicitation of charitable contributions.

2. “Low cost” is $5 indexed forward from 1987 and is indexed for inflation. Multiple low cost items distributed to one potential donee are aggregated and the potential donee must be able to keep the article even if he doesn’t contribute.

Q. Social Clubs.

1. Social clubs described in Section 501(c)(7) are exempt from UBIT only to the extent of “exempt function income,” which generally means income from members. Social clubs are taxable on investment income and income from gains on sale of property in excess of the general $1,000 exclusion from UBIT.

2. The gain on the sale of country club property is exempt from UBIT, if the property was used in the exempt function of the organization (e.g., part of the golf course), to the extent the sales price from the old property is used to buy replacement property used in the exempt function of the

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66 Code Sec. 513(e).
67 Code Sec. 513(h)(1)(A).
69 Code Secs. 513(h)(2) and (3).
70 Code Sec. 512(a)(3).
organization (e.g., a new portion of the golf course) within one year before or three years after such sale. 71

R. Controlled Organizations.

1. Generally speaking, a tax-exempt organization (other than a 501(c)(3) which is a “private foundation”72 may own a for-profit subsidiary with an independent business purpose. 73

2. The exclusions from UBIT of interest, annuities, royalties and rents (the absence of acquisition indebtedness), do not apply to such income received from a “controlled organization.”

3. Control.

a. Control of a corporation means ownership by vote or value of more than 50 percent of the corporation’s stock. For partnerships or other entities, control means ownership of more than 50 percent of the profits, capital, or beneficial interests. Control of non-stock organizations presumably will mean that more than 50 percent of the directors of trustees of the organization are representatives of, or directly or indirectly, controlled by, an exempt organization. Under Treas. Reg. §1.512(b)-1(1)(4)(i)(b), a trustee, director, agent or employee of an exempt organization is a “representative” of that organization; the same regulations provide that an exempt organization controls any trustee or director that it has the power to remove and replace. Constructive ownership rules apply to determine whether the requesting control test is met.

b. The new statutory provisions extend the application of the UBIT rules to second-tier subsidiaries by providing that the constructive ownership rules of Section 318 apply to Section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

c. The new legislation also makes technical modifications to the method provided in Section 512(b)(13) for determining how much of an annuity, interest, rent, or royalty payment made by a controlled subsidiary to a tax-exempt parent is includible in the latter’s unrelated business taxable income. The payments are subject to UBIT to the extent the payment reduces the net unrelated income or increases the net loss of the subsidiary.

d. The modification of the control test to one based on vote or value, the reduction in ownership threshold, the application of the constructive ownership rules under Section 318, and the modifications of the flow-through method apply to tax years beginning after August 5, 1997. There is, however, temporary transitional relief for certain payments. These changes do not apply to any payment made during the first two

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71 Code Sec. 512(a)(3)(D).
72 Code Sec. 4943.places significant limits on the interest which a “private foundation” may have in a business corporation, partnership or proprietorship.
73 See, e.g., Pvt. Ltr. Rul. 9720036 (section 509(a)(2) non-private foundation charity established two for-profit subsidiaries); Pvt. Ltr. Rul. 9722032 (spin-off of a for-profit affiliate and transfer of technology and employees to commercialize pharmaceutical products).
tax years beginning on or after August 5, 1997, if the payment is made
pursuant to a binding written agreement in effect as of June 8, 1997,
and at all times thereafter before the payment.

e. In 2006, Congress further modified section 512(b)(13) to add an
exception for payments from controlled organizations that meet the
requirements of section 482. This exception applies only to payments
made pursuant to a binding written contract in effect on the date of
enactment (August 17, 2006). This special provision was recently
extended and expired on December 31, 2009 but currently pending is
a one-year extension as part of the package of “extenders” currently
pending before Congress.

S. Corporate Sponsorship Payments. Section 513(i) provides that a “qualified
sponsorship payment” is not subject to UBIT. A sponsorship arrangement
meets the IRS’s definition if there is no arrangement or expectation that the
sponsor will receive any “substantial return benefit.” “Substantial return
benefits” are defined as benefits provided to the corporate sponsor other than
(i) permissible forms of acknowledgment or (ii) disregarded benefits, including
benefits that have an aggregate value of not more than 2% of the amount of the
payment. Qualified sponsorships are automatically exempt from UBIT,
whereas payments for substantial return benefits must be analyzed under the
general UBIT rules to determine whether the value of such benefits is subject to
tax.

1. Acknowledgments and Benefits That Are Not Substantial Return Benefits.

The following acknowledgments and benefits are not considered
substantial return benefits.

a. Use or acknowledgment of the name or logo (or product lines) of the
sponsor’s business, as long as such use is not qualitative or
comparative in nature (logos or slogans that are an established part of
the sponsor’s identity are not considered qualitative or comparative);

b. A list of the sponsor’s location, telephone number and/or Internet
address, including a hyperlink from the organization’s website to the
sponsor’s website;

i. a value-neutral description, including display or visual depiction,
of the sponsor’s product lines or services;

ii. the sponsor’s brand or trade names and product listings;

iii. display or distribution of the sponsor’s product, whether for free or
for a charge, at a sponsored activity; and

iv. exclusive sponsorship of an activity, whether overall or
representing a particular industry

v. benefit less than 2% of the sponsorship payment.

2. Substantial Return Benefits.

The regulations provide that substantial return benefits may include (i)
advertising; (ii) exclusive provider arrangements, (iii) goods, facilities, services or other
privileges, and (iv) exclusive or nonexclusive rights to use an intangible asset (e.g.,
trademark or logo) of the organization.
T. Debt-Financed Income

1. Section 514 provides that income otherwise exempt from UBIT may be subject to tax if the income is derived from debt-financed property.

2. “Acquisition indebtedness” is defined as debt incurred by an exempt organization to acquire or improve property that was either incurred prior to the purchase of the property or debt incurred after the property is acquired if the debt would not have been incurred but for the acquisition of the property.74

3. If an exempt organization receives income from debt-financed property a portion of such income is taxable based on a ratio of the average acquisition indebtedness to the average adjusted basis.75

4. If an exempt organization uses 85% or more of the debt financed property for tax exempt related purposes the property will not be treated as debt-financed.76

U. Allocation of Expenses

1. The Code allows deduction of expenses from UBIT for all ordinary and necessary expenses in carrying out the unrelated trade or business if the expense is directly connected with carrying out the business.77

2. “Dual use expenses” are those expenses incurred for both related and unrelated activities. An exempt organization must make a “reasonable” allocation of the expenses between those activities. See Reg. § 1.512(a)-1(c).i78

V. Advertising

a. Journals and other media.

(1) Advertising is taxable if it is in a publication that constitutes a “regularly carried on” activity. See section 512 of the Code.

(2) Advertising in a publication circulated to members “exploits” the exempt function of the organization, which exempt function is

74 § 514(b).
75 Example: Building with an adjusted basis of $100,000 and acquisition indebtedness of $50,000 receives $10,000 in rent. The debt/basis ratio is 50% ($50,000/$100,000); $5,000 of the $10,000 income is taxable.
76 This exception also applies to certain activities that are exempt from UBIT such as research under § 512(b)(7)(7) and (9) and under the voluntary work and donated merchandise exception § 514(b)(1)(D).
77 512(b)(1)(D) Reg. § 1.512(a)(1).
78 The IRS litigation record on reasonable allocations has not been very successful. Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1983) is the leading case in the area. There is a college operated a field house for both its college uses and commercial uses. In determining the expenses against the commercial use, the college used a 3-part methodology of (a) direct expense, (b) variable expense dependent on the percentage of commercial use and (c) fixed expenses that did not vary on actual use. The IRS argued that fixed expense percentage should be calculated on the proportion of time that commercial use have to total time available. The Court agreed with the college’s methodology and held that the time the facility was idle was part of the college’s tax exempt use. While the IRS has never acquiesced in this decision it is generally allowed by university community in allocating expenses for dual use facilities.
furthered by the circulation and distribution of the “readership content” of the publication.\textsuperscript{79}

(3) If expenses of the exempt and non-exempt activities exceed the income of the exempt activity, some exempt expenses may be allocated to the non-exempt (advertising) activity, but a loss may not be created for carryforward of carryback purposes.\textsuperscript{80}

b. If the advertising is profitable after taking into account the direct costs of advertising, the profit may be reduced (but to no more than zero) by the amount which “readership costs” (the cost of producing and distributing the exempt activity readership content) exceed “circulation income” (the subscription income and/or portion of dues attributable to receiving the periodical).

(1) If the periodical is received because “member”\textsuperscript{81} dues are paid, “circulation income”, from dues is based on a proration formula whose numerator is “total periodical costs” and whose denominator is the cost of all the organization’s activities, unless 20% or more of the subscribers are not members (in which case their price is the standard) or 20% or more of the members receive reduced dues for not subscribing (in which case the reduction is the standard).

(2) “Total periodical costs” are direct advertising costs plus readership cost (the cost of producing and distributing the readership content).

(3) Dual expenses may be allocated on a reasonable basis.


a. In January, 1993, the IRS proposed regulations concerning characterization of sponsorship payments by exempt organizations as UBIT.\textsuperscript{82} This followed controversy about private rulings issued in connection with college bowl games and earlier proposed guidelines on which hearings were held on July 21-23, 1992.\textsuperscript{83}

b. In general, the proposed regulations were favorable to exempt organizations. The intent is ‘to distinguish between mere acknowledgment of sponsorship (which is neither advertising nor UBIT) and activities which will constitute UBIT from advertising. The proposed regulations also allowed a payment to be bifurcated between part advertising income and part gift (if the amount of the payment exceeds the fair market value of the advertising), or part advertising

\textsuperscript{79} U.S. v. American College of Physicians, 475 U.S. 834 (1986). The Supreme Court held that revenues from advertising in a scholarly journal were unrelated trade or business income because such advertising was not substantially related to the organization exempt purposes.

\textsuperscript{80} Reg. § 1.512(a)-1(f)(3)(iii).

\textsuperscript{81} As to who is the “member” when local associations rather than individuals are members of a national organization which publishes a periodical, see National Ass’n of Life Underwriters, D.C. Cir. 93-1257 (August 12, 1994), reversing and remanding National Ass’n of Life Underwriters v. Commissioner, 64 T.C.M. (CCH) 379 (1992).


income and part royalty. To the extent possible, the proposed regulations paralleled the Federal Communications Commission (FCC) rules on advertising for public radio and television.

c. Under the proposed regulations acknowledgments could include the following, provided that the effect was identification of the sponsor rather than promotion of the sponsor’s products, services or facilities: sponsor logos and slogans that do not contain comparative or qualitative descriptions of the sponsor’s products, services, facilities, or company; sponsor locations and telephone numbers; value-neutral descriptions, including displays or visual depictions, of a sponsor’s product line or services; and sponsor brand names and product or service listings. Logos or slogans that are an established part of a sponsor’s identity were not considered to contain comparative or qualitative descriptions.\(^{84}\)

d. However, messages or other programming material that include the following were said to constitute advertising: qualitative or comparative language; price information or other indications of savings or value associated with a product or service; a call to action; an endorsement; or an inducement to buy, sell, rent, or lease the sponsor’s product or service. Distribution of samples is not considered an inducement for these purposes. A so-called “tainting” rule (rejected by the new legislation) provided that if any activity constitutes advertising with respect to a sponsorship payment, then related activities that might otherwise be acknowledgments are considered advertising.\(^{85}\)

e. The mere existence of a sponsorship contract was said not necessarily to mean that a sponsorship payment is income from advertising, nor did exclusivity arrangements necessarily mean that a payment was advertising income.\(^{86}\)

f. If the amount of a payment was contingent upon attendance, broadcast ratings, or similar factors, the payment was considered advertising income. However, contingency upon the event taking place or being broadcast does not in itself give rise to advertising income.\(^{87}\)

g. Complimentary tickets, pro-am playing spots, receptions, and other privileges provided by the organization to its sponsors were said not to affect the determination of whether a sponsorship payment is advertising income\(^{88}\) (but may require attention under the solicitation disclosure rules of Section 170).

h. Some open issues included application of the “tainting rule” where, it is clear that the value of the advertising is less than the amount of sponsorship payment,\(^{89}\) the allocation of expenses from exempt function activities where the event has no commercial counterpart,\(^{90}\) and whether such an event is “regularly carried on.”\(^{91}\)

\(^{84}\) Prop. Treas. Reg. § 1.513-4(c)(1).
\(^{85}\) Prop. Treas. Reg. § 1.513(c)(2).
\(^{86}\) Prop. Treas. Reg. § 1.513-4(d).
\(^{87}\) Prop. Treas. Reg. § 1.513-4(e).
\(^{88}\) Prop. Treas. Reg. § 1.513(f).
\(^{90}\) Prop. Treas. Reg. § 1.512(a)-1(e) references the current rules in Reg. § 1.512-1(d)(2) for allocation in the context of “exploitation” of an exempt activity, which rules generally allow allocation of exempt activity costs where the UBIT activity subsidizes the exempt activity, but these rules are applicable only if the event has a commercial counterpart. Prop. Treas. Reg.
The Taxpayer Relief Act of 1997 generally codified proposed regulations issued in 1993 governing the treatment of corporate sponsorship payments. The Act provides that “qualified sponsorship payments” received by an exempt organization or state college or university are exempt from UBIT. A “qualified sponsorship payment” is a payment from which the donor does not expect any substantial return benefit other than the use or

§1.512(a)-1(e), Example 4, may indicate that this requirement may not be applicable, but clarification is needed.

91 See National Collegiate Athletic Association v. Commissioner, supra.