# F. CORPORATE SPONSORSHIP INCOME

**by**
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*Note to Reader, as article goes to print, congressional efforts are underway to exempt from unrelated business income tax certain types of corporate sponsorship income received by exempt organizations conducting public events.*

## 1. Introduction

Corporate sponsorship of nonprofit events is estimated to be $1.1 billion currently and is growing, according to the Special Events Report.[1] In its November 18, 1991, issue, the Report noted the emerging importance of sponsorship arrangements for corporations:

> Companies have never needed sponsorship more because making an impact with traditional media has never been tougher. Advertising is a monologue; the 90's consumer wants a dialogue. Sponsorship is the only marketing platform that links companies with leisure pursuits such as sports, culture, entertainment and causes--precisely the type of communication to which today's consumers will respond.

Faced with shrinking federal and state funding, tax-exempt organizations are aggressively soliciting and encouraging sponsorship arrangements:

> All sponsorship packages are tailored for sponsors so that they receive tangible returns on their sponsorship dollars...[S]uccess of the Fiesta Bowl...attributed to the...sponsors who so generously contribute to the bowl. The Fiesta Bowl invites you to inquire about sponsorships today.[2]

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[1] Published biweekly by International Events Group.

[2] Quote from the 1991 profile written by the Fiesta Bowl which appeared in a Sponsor's Impact workbook published by the International Events Group, Inc. for their annual marketing convention.

On January 17, 1992, the Internal Revenue Service issued News Release 92-4, entitled "EXEMPT ORGANIZATION DONOR RECOGNITION IS NOT ADVERTISING." In the news release, the Service stated that tax-exempt organizations can publicly acknowledge donors for their contributions, but if the organizations conduct advertising for donors the payments are taxable income, not tax exempt contributions. Recent publicity about corporate sponsorship income of college football bowl games resulted in concerns being expressed by many exempt organizations that recognition of contributors would make donations taxable. The Service sought to reassure the charitable community through the news release that it has not changed its position on the issue of recognizing donors.

That publicity was prompted by a recently released, and heavily redacted, technical advice memorandum (TAM 92-47-007 (August 16, 1991)) holding that amounts received by an exempt organization in exchange for certain services provided by the organization constituted unrelated business taxable income.

Controversy and misunderstanding regarding the impact of that holding on charity events began virtually simultaneously with its release (due in large measure to the incomplete information publicly available), and continue. As a result, the Service has taken several innovative steps to reaffirm its position regarding donor recognition and provide needed guidance to the public and IRS field offices alike.

In general, payments an exempt organization receives from donors are nontaxable contributions if there is no expectation that the organization will provide a substantial return benefit. Mere acknowledgement or recognition of a corporate contributor as a benefactor normally is incidental to the receipt of a contribution and is not of sufficient benefit to give rise to unrelated trade or business income. However, where an exempt organization performs valuable advertising, marketing, and similar services, on a quid pro quo basis, for the corporate sponsor, payments made to the exempt organization are not gifts or contributions, and questions of unrelated trade or business arise.

This article explores the issues involved in determining under what circumstances the sponsorship income received by an exempt organization conducting public events may constitute unrelated trade or business income under IRC 512(a)(1), subject to tax under IRC 511.

2. Statutory Framework

In general, income from sponsorship arrangements is subject to unrelated business income tax if it falls within the statutory framework of IRC 511-513.

Section 511(a) of the Code provides, in part, for the taxation of unrelated trade or business income of organizations described in IRC 501(c).

In order for an activity to be an "unrelated trade or business," the activity (1) must be a trade or business, (2) must be regularly carried on and (3) must not be substantially related to an organization's exempt purpose. IRC 512(a)(1), 513(a).

The term "trade or business," in this context, has the same meaning it has in IRC 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities which may be related to the exempt purposes of the organization. See Reg. 1.513-1(b).

Trade or business activities will ordinarily be considered "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations. See Reg. 1.513-1(c)(1). Income producing activities usually carried on by commercial organizations on a year-round basis, if conducted by an exempt organization on an infrequent or intermittent basis, will not constitute the regular carrying on of a trade or business. However, where income producing activities are of a kind normally undertaken by commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season will ordinarily constitute the regular conduct of a trade or business. See Reg. 1.513-1(c)(2)(i)-(iii).

The regulations go on to state that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.

The third and final prong of the test to determine if an activity is an unrelated trade or business is whether the activity is substantially related to the organization's exempt purposes. Whether the activity is substantially related requires examination of the relationship between the business activity that generates the income and the accomplishment of the organization's exempt purpose. To be related, in the statutory sense, a causal relationship must be established which is substantial in nature. Thus, the activities which generate income must contribute importantly to the accomplishment of the organization's exempt purposes to be substantially related. See Reg. 1.513-1(d).

Even if the three tests have been met in determining if there is unrelated trade or business income, income otherwise unrelated will be excluded from unrelated business income tax if it falls within the specific exceptions and exclusions set forth in the Code. Thus, for example, income from a trade or business, substantially all the work of which is carried on by volunteers, is not taxable (IRC 513(a)(1)), nor is income received from royalties (IRC 512(b)(2)).

3. TAM 91-47-007 (August 16, 1991)

In this technical advice memorandum, the Service concluded that the amounts received by an exempt organization in exchange for certain services provided by the organization constitute unrelated business taxable income under IRC 512(a)(1) and, thus, are subject to tax under IRC 511.

From its publicly disclosable version, we can discern few of the important facts upon which the Service focused in reaching its conclusion. In order to raise the required revenue, the organization engaged in income generating efforts. A broker was successful in introducing the exempt organization to an organization and coordinated the drafting of a contract between the two organizations. Commitments in the agreement show that in return for payment, the exempt organization provided a substantial quid pro quo. What the exempt organization provided amounted to much more than mere recognition of generosity; it amounted to a substantial return benefit.

The Service concluded that the services provided by the organization were commensurate with the value of the payments received, and constituted a regularly carried on trade or business, unrelated to the exempt purpose of the organization.

Several key court decisions were used in support of the Service's position. Included among these cases is United States v. American Bar Endowment, 477 U.S. 105 (1986), in which the Supreme Court stated that the standard test for the existence

of a "trade or business" is whether the provision of goods or services is entered into with the dominant hope and intent of realizing a profit. Using that rationale, the Service concluded that by providing valuable services, including advertising services, in return for large payments, the organization was engaged in an activity for the production of income from the provision of services. Hence, the organization was engaged in a trade or business activity.

The question to be resolved, then, was whether the payments were in exchange for goods and/or services provided by the organization. In other words, did the organization provide a quid pro quo in exchange for the payment?

The Service answered in the affirmative, adopting a facts and circumstances approach to determine if the payment was made with an expectation of receiving from the organization a substantial return benefit. Citing Hernandez v. Commissioner, 490 U.S. 680 (1989), the Service stated that a payment to a charity is a contribution or gift for IRC 170 purposes if it is made without an expectation of a return benefit commensurate with the amount of the payment. Normally, limited recognition of a donor's generosity is merely an incidental benefit. This long-standing position of the Service has been enunciated in several different contexts. For example, Rev. Rul. 67-342, 1967-2 C.B. 187, concluded that an exempt educational organization that disseminated its educational material on commercial television did not commercially exploit its exempt purpose by acknowledging the sponsors of its programs with a statement that the programs had been paid for as a public service by the sponsors. Similarly, Rev. Rul. 77-367, 1977-2 C.B. 193, held that an organization that operated a replica of a historical village did operate for exclusively exempt purposes despite the benefits to a corporate sponsor of having the village named after it, having its name mentioned in the organization's publications, and having its name associated with the village in the corporation's own advertising.

In this instance, however, the Service determined that the package of benefits the organization provided goes far beyond what previously had been established as recognition of a benefactor that results in merely an incidental benefit. Indeed it amounts to a substantial return benefit that is commensurate in value with the payments made.

Noting that there is no requirement that unfair competition be present in order to impose the unrelated business income tax, the Service proceeded to conclude that the organization's advertising activities did not contribute importantly to the organization's exempt function (United States v. American College of Physicians, 475 U.S. 834 (1986)). Furthermore, the advertising and promotional activities were

determined to be "regularly carried on," rather than intermittent, thus satisfying the final requirement that must be met in order for there to be unrelated trade or business income. With regard to the "regularly carried on" test, the Service stated that the determination should not be based merely on the duration of the game. Rather, it is necessary to consider the normal time span for the trade or business, together with whether the activity is carried on in a manner comparable to that of a non-exempt organization. The Service's disagreement with the Tenth Circuit's National Collegiate Athletic Association decision was noted as well as the fact that the NCAA case was factually distinguishable from that at issue here. (See National Collegiate Athletic Association v. Commissioner, 914 F.2d 1417 (10th Cir. 1990), action on decision, 1991-015 (July 3, 1991)(nonacq)).

Finally, the Service dismissed the argument that the payments to the exempt organization constituted a royalty. A royalty is a payment for the use of a valuable right. In the instant case, it is the exempt organization that provides various services and is so contractually required. Thus, the Service concluded that any argument that the payments are royalties is misconceived. In support of its conclusion, the Service cited Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner, 833 F.2d 717, 723-24 (7th Cir. 1987) (exempt organization actively involved in the production of income); National Water Well Association, Inc. v. Commissioner, 92 T.C. 75, 99-101 (1989) (same effect); National Collegiate Athletic Association v. Commissioner, 92 T.C. 456, 468-70 (1989) (same effect), rev'd on other grounds, National Collegiate Athletic Association, supra.

Furthermore, the Service likened the case before it to situation 2 of Rev. Rul 81-178, 1981-2 C.B. 135. In situation 1 of the revenue ruling, the Service considered certain payments to an exempt labor organization from various business enterprises for the use of the organization's trademark and similar properties. The Service ruled that the payments were gross income from an unrelated trade or business. However, because they related to the use of a valuable right, they were royalties that were excluded from the computation of unrelated business taxable income under IRC 512(b)(2). In situation 2 of this revenue ruling, the additional fact that the agreements required the personal services of the organization's members in connection with the endorsed products and services caused the payments to be characterized as compensation for personal services. The payments in situation 2 were not royalties and, thus, were not excepted from the definition of unrelated business income.

## 4. The Fireworks Begin

As soon as TAM 91-47-007 became public, the exempt community erupted with outrage and concern. Coalitions began forming in an all-out effort to stop this perceived full-scale assault by the IRS on vital fundraising activities of exempt organizations. Many organizations felt that their very existence was threatened. The heavily redacted version of the TAM fueled rather than assuaged their worst fears. Even before the memorandum was made public, bills were introduced in the U.S. House of Representatives (H.R. 2464, with 99 co-sponsors currently) and in the U.S. Senate (S. 866, with 25 co-sponsors currently) which would exempt from UBIT certain types of sponsorship revenue from qualified amateur athletic event activities.

In direct response to the growing controversy, publicity, and misunderstandings regarding the impact of the Service's ruling on other sponsored public events, the Service took several significant, and, in one instance, highly innovative, steps:

> -- Initiated Compliance 2000 initiatives which might lend themselves to further review of organizations with sponsorship arrangements for the purpose of encouraging and securing voluntary compliance to the greatest extent possible;
>
> -- Issued IR-92-4, dated January 17, 1992, to reassure exempt organizations that mere recognition of contributors will not make donations taxable;
>
> -- Adopting an approach never before used, published for public comment proposed examination guidelines on the treatment of corporate sponsorship income (Announcement 92-15, 1992-5 I.R.B. 51).

## 5. IR-92-4

The publicity surrounding the first sponsorship case had placed the Service in a difficult position. Since the issues involved arose in a particular case, the questions that had to be answered initially were - especially in light of prohibitions against disclosing taxpayer information - how to convey to the public the nature of the Service's concerns, and, how to alleviate public concerns about how the ruling affected them specifically. There were also administrative problems that needed to be addressed: (a) how examination activity could be focused so that agents are not chasing false issues, and (b) how to get timely guidance out to the public that would allow individual groups to determine accurately if and how their sponsored events are affected.

The solution decided upon was two-fold: IR-92-4 and Announcement 92-15, the proposed examination guidelines.

The predominant purpose of IR-92-4 was to reassure the exempt community that Service policy has not changed. The title of the information release boldly proclaimed it: "EXEMPT ORGANIZATION DONOR RECOGNITION IS NOT ADVERTISING." Tax exempt organizations can publicly acknowledge donors for their contributions, but if the organizations conduct advertising for donors the payments are taxable income, not tax exempt contributions. Noting several examples of incidental recognition that is not advertising, the information release went on to state that associating the name of the sponsor with the name of the exempt organization's event is not, by itself, advertising that would trigger UBIT. Rather, all the facts and circumstances of the relationship between the sponsor and exempt organization must be considered. Items to consider include the value of the service provided in exchange for the payment and the terms under which payments and services are rendered.

The release identified some indicators that an exempt organization is engaged in the unrelated business activity of advertising to include:

> -- providing exposure of the sponsor's name, logo or corporate message according to negotiated terms of a contract or other agreement;
>
> -- agreeing to verbally or visually maximize donor name or logo exposure in the media and during the sponsored activity;
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> -- linking the amount of payment to the amount of exposure that the donor's name or logo receives; or
>
> -- agreeing that payment is contingent upon the organization's securing television or other marketing contracts to provide the sponsor's name widespread exposure.

Additionally, the Service announced and released the proposed examination guidelines contained in Announcement 92-15.

6. Announcement 92-15

The examination guidelines have been issued in proposed form for public comment, as well as a public hearing, for several important reasons. The announcement method is a timely way to publicize those factors which the Service concludes make these arrangements akin to advertising. Public comments are

solicited to educate the Service as to the full range of activities that might be affected by the corporate sponsorship rules. It gives concerned groups a streamlined method of determining whether they are affected. Ultimately, it is expected that the guidelines will set forth more comprehensive standards than currently exist so as to give organizations greater certainty as to where they stand and how to structure activities to meet the requirements of the law. And, importantly, examination guidelines, as instructions to agents, will help the Service to better target the use of compliance resources in this area.

The first several pages of Announcement 92-15 provide the foundation and structure for the proposed examination guidelines that follow. The guidelines do not set forth new law; the law since the guidelines have been published is the same as before they were announced. The law is that, under certain circumstances, the corporate sponsorship income received by an exempt organization conducting public events may constitute unrelated trade or business income that is subject to tax. The guidelines provide examiners with certain indicators and analytic tools to use during examinations to evaluate the corporate sponsorship payments and make a determination as to whether the organization is engaged in an unrelated trade or business.

In general, it is not the intention of the guidelines that any one event or any particular organization or any one factor will automatically trigger UBIT. Nor does the mere fact that the sponsorship payments are governed by a written contract fatally taint the income received by an exempt organization. Rather, the guidelines are designed to flag cases in which corporate sponsorship payments are likely to be problematic. The instructions then point out to examiners how to proceed with the audit.

The guiding principle is set out in the very first paragraph of the guidelines, referring to corporate payments:

> (1) Frequently corporate donors provide financial and other support for the activities of exempt organizations. Normally this support is in the form of contributions or gifts and does not constitute any trade or business income to an organization. In certain instances, however, arrangements have been entered into with corporate sponsors that provide the sponsors with valuable marketing and other services in return for their support. Where the benefits that are provided are substantial, payments received by the exempt organization from the corporate sponsor may constitute unrelated business income subject to tax under section 511 of the Internal Revenue Code. Section 178.1.

Corporate payments to an exempt organization are thus viewed by the Service as normally being a gift or contribution, and not subject to UBIT. Payments from sponsors are nontaxable gifts or contributions where there is no expectation that the organization will provide the sponsor a substantial return benefit. Mere recognition of the sponsor as a benefactor ordinarily will not be a substantial return benefit.

The guidelines attempt, then, to sort out those instances where sponsors pay amounts which are nontaxable gifts or contributions. Clearly, the concerns about the nature of the payment grow as the exempt organization becomes active in providing services as a condition for payments, and those services are above and beyond those acts which the organization would otherwise do in staging the event.

The examiner's determination does not conclude with a finding that the payments constitute unrelated business income. The guidelines point out that even if the payments are for a substantial return benefit, certain exclusions and exceptions, like those available for royalties and volunteer labor, may apply.

The guidelines are set up in such a manner that, first and foremost, certain activities of exempt organizations, and certain organizations themselves, are identified as normally being beyond the scope of the guidelines, even before the guidelines themselves are outlined. This is done in two ways. First, examples of recognition (as opposed to promotion) of a corporate sponsor that do not generally give rise to unrelated business income are given: naming a university professorship, scholarship or building after a benefactor; acknowledging an underwriting of a public radio or television program or museum exhibition; and listing a contributor to a fund raising event or to a performing arts organization in an accompanying program. Section 178.1(2). Second, the guidelines set forth, by means of an audit tolerance, that these guidelines will generally not apply to an organization that is of a purely local nature, receives relatively insignificant gross revenue from corporate sponsors, and generally operates with significant amounts of volunteer labor. Section 178.2.

It is the intent in both of these provisions to direct examiners away from those areas where the likelihood of any corporate sponsorship generating UBIT is very slight and toward those cases where the likelihood is much greater. This not only makes the most productive use of audit resources, but also provides organizations with an immediate and real safe-haven.

Furthermore, in the introductory paragraphs to the guidelines, it is reiterated that mere donor name recognition, including associating a sponsor's name with the event, does not, in itself, trigger UBIT. Rather, the Service will examine all relevant

facts and circumstances in deciding if a payment is taxable, including: the value of services provided in exchange for the payment; the terms under which payments and services are rendered; the amount of control that the sponsor exercises over the event; and whether the extent of the organization's exposure of the donor's name constitutes significant promotion. Section 178.1(3). It is intended that all of these factors be considered during an examination of the sponsorship arrangement.

It is only after this statement of guiding principles, exclusions and audit tolerance levels that examiners are given specific instructions on how to scrutinize the remaining cases to determine whether the organization is performing substantial services or providing other benefits in return for the payment received. Section 178.3. The guidelines identify documents that should be examined as well as provisions that may be of concern. Factors to be considered as tending to indicate an unrelated trade or business include whether the corporate sponsorship contract/arrangement requires the corporate sponsor's name or logo to be included in the official event title, prominently placed through the stadium, arena, or other site where the event is held, printed on material related to the event, or placed on participant uniforms or other support personnel uniforms.

Also, the examiner should review whether the arrangement requires: that the corporate sponsor refer to its sponsorship in advertisements over the course of the contract; that participants be available to the sponsor for personal appearances and endorsements; or that the exempt organization arrange for special seating, accommodations, transportation and hospitality facilities at the event for corporate sponsor clients or executives. Other factors to be considered include whether the contract/arrangement requires media coverage of the event, or provides for promotional arrangements that do more than merely acknowledge a sponsor (consider size, color and content of acknowledgement and listing of products and services). The examiner should also determine whether the payment is contingent upon the exempt organization securing television, radio, or other marketing contracts to provide the sponsor's name or logo widespread exposure or upon television ratings of the event. Other factors for consideration include whether the arrangement provides that any renewals or extensions of sponsorship are contingent upon continued public exposure; or whether such contract/arrangement can be terminated for failure to provide certain benefits. The examiner should further review whether the segment of the public expected to see the identifying sponsorship information can reasonably be expected to purchase the sponsor's goods or services and whether additional services are provided to the corporate sponsor through the same or ancillary contracts.

The purpose of listing all such factors to be taken into consideration is to ensure that examiners can discern exactly what the exempt organization must do and how it must do it for the corporate sponsor. Donor recognition approaches commercial promotion, advertising and marketing services when the sponsor's name must be displayed in a particular manner or mentioned a specified number of times, especially when coupled with statements relating to products and services that are directed at an audience likely to be purchasers. This type of sponsorship is vastly different from a televised program or an event pamphlet that says: "This event is made possible by a grant from the X corporation."

The final paragraphs of the guidelines (section 178.3(6)-(9)) are general reminders for completion of the examination:

> --determine if all the Code sections 511-513 requirements are met;
>
> --determine whether any of the exceptions or modifications for rents or royalties are applicable;
>
> --remember that it is not determinative whether the sponsor treats the sponsorship payments as contributions or business expenses;
>
> --if there is unrelated business income, review the basis for allocation of expenses; and,
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> --document the extent to which the sponsorship income is accurately and consistently reported on Forms 990 and 990-T.

Announcement 92-15 concludes with a solicitation for public comments, which were initially due April 3, 1992. The comment period was extended from April 3, 1992, to May 18, 1992, in Announcement 92-58, 1992-15 I.R.B. 54, dated April 13, 1992. The Announcement also stated that if warranted, after consideration of the comments received, the Service will schedule a public hearing to discuss further the proposed examination guidelines before they are finalized. (As discussed in detail later, following a review of the comments submitted, a public hearing was scheduled for July 21-23, 1992.)

Over 300 comments have been submitted on the proposed guidelines. The greatest number of comments came from social services organizations, arts groups (including museums, theatres, ballet companies, operas and symphony orchestras), festivals and fairs, and amateur athletic associations. Most of the comments requested a public hearing. Many are quite constructive, pointing out particular problem areas and offering specific recommendations. Even those commentators

most opposed to the guidelines applauded this new approach that allows the exempt organizations community to have meaningful input before rules affecting them are finalized.

In general, many of the organizations feel that the guidelines are too broad and vague, and leave too much discretion in the hands of examiners. Essential terms, such as "substantial return benefit" and "purely local in nature," need definition. Citing lack of definition, clarity and scope, few found the audit tolerance provision helpful. The guidelines, it is argued, fail to provide adequate guidance so that an organization could determine prospectively with reasonable certainty what is sponsorship recognition and what is advertising. Others aver that the guidelines wrongly categorize normal fundraising and the associated traditional acknowledgement of donors as the sale of advertising. For example, some commentators express serious concern that identifying product and/or service lines or slogans are listed as indicators of advertising rather than donor recognition. Others urge that incidental benefits, such as tickets, VIP dinners and hospitality suites, given to donors should not taint the contribution. Some expressed a need for guidance on deduction and allocation issues, and urge that the rules applied in computing unrelated business taxable income in the case of exempt organization periodicals be applied in sponsorship cases. See Reg. 1.512(a)-1(f)(2).

All in all, not one provision contained in the proposed guidelines escaped the ire of the commentators, who urged substantial revisions to, if not complete withdrawal of, the guidelines. While most accepted that clearly advertising income was taxable, these organizations also urged a very restrictive definition of what is advertising in the context of fundraising and donor recognition practices.

7. Pending Issues

There are certain important issues that have not been addressed in the proposed examination guidelines. While these issues have not reached ultimate resolution, they are under active consideration in the National Office.

A. Expense Allocations

The proposed examination guidelines remind the examiners that, if there is unrelated business income, the examiner should examine the overhead, administrative, and other expenses claimed by the exempt organization and review the basis for allocation of the expenditures. Section 178.3(8). No further guidance is

provided, however, on which expenses can be deducted from the sponsorship income in calculating the unrelated business taxable income.

The Code and regulations contain a general framework for determining how expenses are to be allocated. Exempt organizations may deduct expenses "directly connected with" the carrying on of such trade or business (IRC 512(a)(1)). Reg. 1.512(a)-1(a) further provides that for an expense to be directly connected with the conduct of the unrelated business, the expense must have "proximate and primary relationship" to the carrying on of the business.

Expenses that are attributable solely to the conduct of the unrelated business activities are proximately and primarily related to that business activity and qualify for deduction to the extent that they meet the requirements of section 162, section 167 or other relevant provisions of the Code. Thus, for example, salaries of personnel employed full-time in carrying on unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of the unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167. Reg. 1.512(a)-1(b).

When facilities or personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses must be allocated between the two uses on a reasonable basis. This is the so-called "dual use" rule. Reg. 1.512(a)-1(c).

The regulations go further and provide a special rule, the so-called "exploitation" rule, for those cases where gross income is derived from unrelated trade or business activity which exploits an exempt activity. Under Reg. 1.512(a)-1(d), in general, in such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income. This is due to the fact that, since such items are incident to an activity which is carried on in furtherance of the organization's exempt purpose, they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity. An exception to this rule is set forth in Reg. 1.512(a)-1(d)(2).

Section 1.512(a)-1(d)(2) of the regulations provides that where unrelated trade or business activity is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is of a type normally conducted

by taxable organizations in pursuance of such business, the exempt activity expenses may offset the gross income from the unrelated activity, but only to the extent that the exempt activity expenses exceed the exempt activity income, and the allocation of such excess to the unrelated business activity does not result in a loss. Under this rule, exempt activity expenses must be allocated first to the exempt activity. Furthermore, such exempt activity expenses may not be taken into account in computing unrelated business taxable income attributable to an unrelated trade or business activity not exploiting the same activity.

The one example of an exploitation case that is mentioned in the regulations is the sale of advertising in a periodical of an exempt organization. Reg. 1.512(a)-1(d)(1). Under Regulation 1.512(a)-1(f), special rules are set forth that address the determination of unrelated business taxable income derived from the sale of advertising in an exempt organization's periodical. The question now under consideration by the Service is whether the allocation rule governing exploitation of exempt activities is the appropriate rule to use in sponsorship cases. If the exploitation allocation rule is determined to be appropriate, then the question presented is whether to apply the rules governing advertising income in exempt organization periodicals to sponsorship income.

Another question that must be addressed as well concerns how to treat certain expenses, such as payments to other exempt organizations, for purposes of determining allowable deductions. Consideration is being given as to whether such payments are deductible under IRC 170 or 162. Some of the comments on the proposed examination guidelines do address these complex allocation issues and are sure to be the subject of further analysis and discussion in the near future.

B. Fragmentation of Sponsorship Income

Another issue that warrants additional attention is whether, in connection with corporate sponsorships, the presence of an advertising benefit automatically makes the entire payment unrelated business taxable income.

Some exempt organizations have argued that under the general rule that any reasonable allocation method may be used, an exempt organization that receives sponsorship income is permitted to use a fragmentation approach. Thus, if the exempt organization can demonstrate that the advertising benefit is less than the total payment, then the excess payment may be excluded from UBIT as royalties or contributions.

However, if such a fragmentation approach were to be used, the organization would have to show a reasonable basis for the allocation for each of the items of sponsorship payment so fragmented. Furthermore, it is possible that the approach taken in G.C.M. 39827 (August 20, 1990) would apply. There, Chief Counsel concluded that certain payments to an exempt organization allocated under a licensing agreement for the use of the organization's name and logo were inseparable from and essentially for the use of the organization's mailing list and, as such, the entire payment amount constituted unrelated business taxable income. See also LTR 90-29-047 (April 27, 1990), which revoked LTR 88-28-011 (March 31, 1988). Issues with respect to "fragmentation" or "inseparability" are likely to be the subject of further consideration.

8. Latest Developments

At this writing, public hearings on the proposed examination guidelines for treatment of corporate sponsorship income have been announced by the Service, in light of the high volume of comments and requests for hearings that were received. (See Announcement 92-88, I.R.B. 1992-26, dated June 29, 1992.) The hearings are scheduled for July 21, 22 and 23, 1992.

In announcing the hearing, the Service also requested that oral comments include a discussion of some or all of the following issues:

(1) Should the audit tolerance provision of the guidelines (section 178.2) be replaced with a "safe harbor", which excludes from the examination guidelines (a) those exempt organizations below a specified size; and/or (b) any sponsorship payments which do not exceed a certain dollar amount?

(2) Should the facts and circumstances approach set forth in the proposed guidelines be replaced with a more mechanical test? If so, what should that test be?

(3) Should the guidelines list specific factors that are considered as tending only to show mere donor recognition? If so, what are such specific factors? What kinds of benefits are so insubstantial that they are merely "incidental" to the arrangement?

(4) What are important examples of mere recognition or acknowledgement of corporate contributors?

(5) What factors indicate that advertising is involved?

(6)

(7) When do identifying references to a corporate sponsor's products, services or slogans constitute advertising? Is the frequency of such identifying references relevant?

(8) Should unrelated business income tax liability only arise where sponsorship income is used for advertising services? How should advertising services be defined? Are promotional and marketing services included?

(9) How should expenses that are not directly related to advertising be treated? Is the allocation rule governing exploitation of exempt activities the appropriate rule to use in sponsorship income cases? If the exploitation method does not apply, what is a reasonable method for allocating items of overhead expenses?

(10) How should certain expenses, such as payments to third-party exempt organizations, be treated?

(11) Should the guidelines provide that, under a reasonable allocation method, an exempt organization may use a fragmentation approach to demonstrate that the sponsorship income is partly a contribution or royalty?

In addition, the Service invited oral comments on any other issue relevant to the question of the treatment of corporate sponsorship income.