

## **E. MARKETING TRAVEL TOURS, INSURANCE, AND AFFINITY CARDS THROUGH THE MAIL**

by

**Barbara E. Beckman and David W. Jones**

### **1. Introduction**

Insurance, travel tour, and affinity card marketing programs are all activities that exempt organizations may conduct for several reasons: to further exempt purposes, to provide a convenient service to members, and, often, as a way to raise money from those members purchasing the item involved. Frequently, organizations that conduct marketing activities do so for more than one of these reasons. Occasionally, organizations that have more than one reason tend to be vague in describing the character of these activities. This lack of clarity is reflected in how the organizations view what is in its essence a sales transaction.

In some cases organizations think of the activity as they would a traditional fund raising event. These organizations characterize the difference between the cost of an item sold and the amount they receive from the sale as a "donation", and so advise the individuals who purchase the items. (Clearly, the organizations that do this do not fully appreciate what is involved in making a deductible donation for purposes of IRC 170.) Those organizations that take this view tend to report the income from these activities as "contributions" on their Forms 990. Other organizations, while realizing that this is income from a sale, assume that the sales activity is related to their exempt function and report the income as "program service" income. Often, because the products an organization markets have a special appeal to its members, the organization assumes that the sale of the product is a related activity. For example, an art museum may market European tours to its members that include scheduled visits to famous European museums. The mere fact that the tours include visits to museums, does not make the tours educational within the meaning of Regs. 1.501(c)-1(d)(3). Moreover, that the tours have a special appeal to the museum's members, does not make the sales activity "substantially related" within the meaning of Regs. 1.513-1(d).

Finally, organizations frequently enter into agreements with commercial entities dealing with the marketing of these products through the mail. Income that organizations receive from these agreements is often characterized as a "royalty", since royalties are excluded from unrelated business taxable income under IRC 512(b)(2). However, these transactions must be carefully examined to: (1) be sure

that the income received has been properly characterized as a royalty - whether the organization's role in the sales activity involves more than passive use of its name or logo; and (2) be sure that no other activity taxable under the unrelated business income tax provisions - such as the sale of mailing lists under 513(h) - is involved.

#### A. Scope

This topic will examine the issues that apply to the marketing of these particular products through the mail. It will also discuss the post office restrictions on this kind of marketing. The post office restrictions are included for several reasons. First, the post office restrictions play a role in determining whether a marketing program is economically feasible. Second, there is an impact under the post office restriction of a determination that the sale of a product through the mails is not related to an organization's exempt purpose. Third, there may be a potential value in coordinating with the post office for Service compliance programs.

### 2. Whether Marketing These Services Is Related to An Organization's Exempt Purposes

#### A. Travel Tours

While travel may be a learning experience, not all travel tour packages are educational within in the definition of Regs. 1. 501(d)(3). That regulation indicates that to serve an educational purpose, an activity must relate to "The instruction or training of an individual for the purpose of improving or developing his capabilities." A great many travel tour packages called "learning vacations" or "study tours" offer activities such as sightseeing and shopping that are not related to either "the instruction or training of an individual [etc.]". Not surprisingly, an analysis of the content of these tours frequently indicates that more than an insubstantial part of a participant's time is spent in ways that are not educational within the meaning of the regulation.

Rev. Rul. 70-534, 1970-2 C.B. 113 provides an example of how the rule operates in this area. That revenue ruling concerns an organization whose primary activity was conducting study tours where certified teachers taught junior college level courses on subjects related to the specific area visited on a particular tour. The tours were several weeks in length, with five to six hours of each day devoted to study. Students prepared reports, took exams at the end of the program, and school credit was given for participation. The ruling concluded that the organization was educational within the meaning of IRC 501(c)(3) of the Code.

Contrast the facts in Rev. Rul. 70-534, with the facts in a recent case, International Postgraduate Medical Foundation v. Commissioner, 56 TCM 1140 (1989), and it should be clear that some tour programs are only incidentally educational. In the International Postgraduate Medical Foundation case, the tours, which were marketed to doctors, lasted three weeks. Less than half the days, and only four and a half hours of each of those days, was spent on an educational program consisting of seminars on medical topics. The families of the doctors also went on the tours without taking part in any of the educational activities. In addition, the brochures advertising the programs emphasized the tours' recreational and sightseeing activities. Because the organization could not demonstrate that the noneducational activities were incidental to the seminar program, the Court held that the organization was not exempt under IRC 501(c)(3). Due to the substantial private benefit involved in the case, in addition to the commercial nature of the tours, the Court held that the organization was not operated exclusively for exempt purposes.

Rev. Rul. 77-366, C.B. 1977-2, 192 reaches the same conclusion. The revenue ruling involves an organization that conducted 14 day cruises that included a schedule of lectures, discussion groups, and workshops on religious topics. During the nine days the ship is at sea, lectures, discussions, and workshops are held for about four hours by theologians and religiously oriented psychologists. The rest of the time is available for meals, social activities etc. The remaining five days are spent in port where arrangements are made for sightseeing and shopping. Citing Better Business Bureau v. United States, 326 U.S. 279 (1945), the organization was denied exemption under IRC 501(c)(3).

Under the unrelated business income provisions the question is whether the sale of the tours has a substantial "causal relationship" to the organization's exempt purposes within the meaning of regs. 1.513-1(d)(2). Rev. Rul. 78-43, 1978-1 C.B. 164, held that a university alumni association's travel tour program did not meet the requirements of the regulation because no formal educational program was conducted on the tour.

PLR 9027003 described tour programs which were advertised in brochures that emphasized the shopping, social and recreational activities, in addition to the educational aspects of the tour. The PLR compared three different tour programs presented by the organization for purposes of highlighting those elements that should be present in an educational tour. Tour One had optional lectures on six of the tour's seven days. Tour Two provided seven optional hours of lectures during a sixteen day tour. Tour Three consisted of a fifteen day tour during which six and a half days of

required classes were held at a college, as well as four days of field trips related to the subject studied in the classroom, and a reading list was provided to participants. The ruling concluded that Tours One and Two were not organized study programs and the substantial social and recreational aspects of these tours demonstrated the lack of a causal connection between the tours and the achievement of an educational purpose. Tour Three was found to have the requisite causal connections because a significant part of the program (ten and a half out of fifteen days) consisted of organized educational activities.

PLR 8832003 involved a tour designed as a foreign exchange program for members of a particular profession. The promotional material for the tour indicated that the participants would spend at least one of their time with fellow professionals. No analysis was made of how the time would be spent. The main issue discussed in the PLR was whether UBI resulted from the presence on the tour of the spouses and dependents of professional participants. Although the organization permitted family members to attend the educational programs, the evidence showed that separate noneducational activities were scheduled for the wives and children of the professionals. Thus, their attendance was not mandatory, and their time was principally spent in recreational and social activities.

Under IRC 513(c) of the Code, an activity does not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. The ruling concludes that the income from the travel fees paid by spouses and dependents would be subject to UBI because the family members' participation did not further the educational purposes of the program and did not contribute importantly to the organization's exempt purposes. PLR 8909004, which supplemented PLR 8832003 recommended closer analysis of whether the organization operated for educational purposes.

## B. Insurance

Over the years, the Service has consistently taken the position that an organization (usually an IRC 501(c)(6) business league) which acts as a group insurance policyholder for its members and collects a fee for performing assorted administrative services, is normally involved in an unrelated trade or business. This issue has been the subject of numerous CPE topics - the most recent of these an update in the 1990 CPE.

There are statutory exceptions to this rule. For example, IRC 501(c)(8) and IRC 501(c)(9) among others allow the provision of certain kinds of benefits.

There are exceptions to the rule that, while not specifically provided by statute, are a matter of interpretation. The regulations under IRC 501(c)(5) provide that labor organizations "have as their objects the betterment of those engaged in [labor or horticultural] pursuits." Rev. Rul. 62-17, C.B. 1962-1, 87 holds that the payment of death, sick, accident, and similar benefits to members with funds contributed by members does not preclude exemption under IRC 501(c)(5). Rev. Rul. 62-17 concludes that the legislative history of IRC 501(c)(5) indicates that labor organizations were exempted, in part, because they operated as mutual benefit associations providing these kinds of benefits to members. Cf. California Farm Bureau Federation v. United States, 91-1 U.S.T.C. para. 50,300, (E. Dist. Cal. 1991).

It should be noted that this is not an issue for many labor unions, since insurance benefits are normally benefits that are bargained for collectively and paid by an affiliated IRC 501(c)(9) organization.

Citing Rev. Rul. 62-17, PLR 8924001 holds that a labor union that provides group insurance for its regular members is not involved in an unrelated trade or business. However, the PLR also holds that income from the provision of such insurance to "associate members," who do not have full rights and privileges in the union and whose "dues" permit them to participate only in the insurance program, is taxable as unrelated trade or business income. Two relatively recent cases are in accord with the latter view.

In American Postal Workers Union, AFL-CIO v. U.S., 925 F.2d 480 (D.D.Cir. 1991), reversing 90-1 U.S.T.C. para. 50,013 (D.D.C. Dec. 19, 1989), the Union, exempt under IRC 501(c)(5) of the Code, sponsored a health insurance plan that was available to its postal worker members and to certain federal employees that were not postal workers. In order to participate in the insurance plan, non-postal workers, called "associate members" under the insurance plan, were required to pay regular premiums and to pay a \$35 charge that the Union designated as "dues". This payment of dues only permitted associate members to purchase insurance, it did not provide them with any other union privileges. The District Court had concluded that the income from dues paid by associate members was not unrelated business income under IRC 511-513 of the Code.

The Court of Appeals reversed, holding that the providing of insurance to associate members was unrelated to the Union's exempt purpose of representing the

interests of postal workers. Associate members were considered members of the Union only for purposes of purchasing insurance. Because they were not actually members of the organization, the marketing of insurance to them only related to the Union's purposes only to the extent that it brought in revenue. The characterization of the payments as "dues" and the nonmembers as "associate members" did not change the fact that the activity constituted the providing of insurance to nonmembers.

Further, the Court of Appeals concluded that the Union's substantial net income from this activity indicated that the organization's purpose in providing insurance to the associate members was to bring in a profit. The providing of insurance to Union member postal workers was not at issue, as the insurance benefits are related to the organizations IRC 501(c)(5) purpose of bettering working conditions for postal workers.

Similarly, in National Association of Postal Supervisors v. U.S., 21 Cl. Ct. 310 (1990), affirmed 944 F.2d 859 (Fed. Cir. 1991), the Court of Appeals held that income received from nonpostal worker federal employees for participation in a health plan sponsored by the National Association of Postal Supervisors (NAPS), under an arrangement nearly identical to the insurance program in American Postal Workers Union, supra, resulted in unrelated business income to NAPS. The Court of Appeals agreed with the District Court that, regardless of the fact that NAPS charged nonpostal workers "dues" and classified them as "limited benefit members" of the Union, the only benefit received from the payment was the opportunity to participate in the insurance program. It was clear that the activity was regularly carried on and that NAPS conducted the activity with the hope of making a profit.

National Water Well Association v. Commissioner, 92 T.C. 75 (1989), provides an example of the contrast in approach between business leagues under IRC 501(c)(6) and labor organizations under IRC 501(c)(5). National Water Well, exempt as a business league under IRC 501(c)(6), was a group policyholder of an industry casualty insurance program that it made available to its membership. The Water Well Association had conducted a study that found that water well drillers had a better safety experience record than oil well drillers - a group with which the water well drillers had been classified for insurance purposes.

Because of the study, a commercial insurance company had agreed to classify water well drilling as a less risk prone industry and to provide insurance coverage. This coverage included workers' compensation, general liability, business equipment liability, and automobile insurance. National Water Well actively endorsed and sponsored the program. The organization received a dividend from the insurance

company, part of which it retained and a portion of which it returned to member insureds.

The Tax Court concluded that the activity, which was regularly carried on, was a trade or business because the organization's active participation in the providing of insurance manifested an intent to derive a profit from the activity. Also, the Court held that providing the insurance was not substantially related to the organization's exempt purpose. The Court rejected National Water Well's argument that the activity was related because the organization used some of the dividends it retained to promote safety in the water well industry. Rather than improving business conditions for the water well industry as a whole, the insurance activity primarily benefited individual members in direct proportion to the fees that they paid.

In the most recent case, Professional Insurance Agents of Washington v. Commissioner 875 F. 2d 870 (9th Cir. 1989), the 9th Circuit affirmed the Tax Court's determination that fees received by an IRC 501(c)(6) business league comprised of independent insurance agents for promoting a malpractice insurance program constituted unrelated business taxable income. (For a thorough analysis of insurance and exemption under IRC 501(c)(6), See 1981 CPE at page 279.)

### 3. Whether The Marketing Program Constitutes A Trade Or Business

#### A. The Issue

In addition to considering whether an activity is related or not, a second consideration is whether the organization involved is engaged in a trade or business or whether is engaged in a nontaxable activity - e.g. fund raising. (The term "fund raising" is not defined in the Code or regulations, but where it is used - Regs. 1.513-1(c)(2)(iii) and in the American Bar Endowment case discussed, *infra* - it is used to describe an activity that is not a trade or business.) Prior to the decision in the American Bar Endowment case, the courts had developed two standards for determining this question. The first standard, the "profit motive" test, had been developed in several Courts of Appeals and applied in insurance sales cases. See Professional Insurance Agents of Michigan v. Commissioner, 726 F. 2d 1097 (6th Cir. 1984); Carolinas Farm & Power Equipment Dealers v. United States, 699 F. 2d 167 (4th Cir. 1983); and Louisiana Credit Union League v. United States, 693 F. 2d 525 (5th Cir. 1982). The second standard, the "commercial, competitive manner" test was the product of the Claims Court and had been upheld on Appeal in Disabled American Veterans v. U.S., 227 Ct.Cl. 474, 650 F.2d 1178 (Ct. Cl. 1981).

## B. American Bar Endowment

U.S. v. American Bar Endowment, 477 U.S. 105 (1986), concerned an insurance program marketed by American Bar Endowment ("ABE") to its members. Because its members have low mortality and morbidity rates, the cost to ABE of providing the insurance was less than that of commercial insurance providers. ABE, however, priced the premiums that it charged to its members at commercially competitive levels.

The difference between the cost of the insurance and the premium paid to the insurance carriers was returned to ABE in the form of a "dividend." Under the terms of its program, ABE kept the "dividends". ABE advised its insured members that each member's share of the "dividend" less administrative costs was a tax-deductible contribution used to support ABE's charitable program.

The Claims Court concluded that this arrangement did not result in unrelated business income and the Court of Appeals for the Federal Circuit agreed on appeal. However, the Supreme Court reversed the lower courts' decisions on the UBI issue, concluding that the insurance program was carried on for the production of income and that it had the characteristics of a business.

Under regs. 1.513-1(b), any activity which is carried on for the production of income and which "otherwise possesses the characteristics required to constitute a 'trade or business' within the meaning of section 162" is a trade or business for purposes of the UBIT provisions. The Supreme Court rested its decision on the "profit motive" theory of IRC 162. Under this theory the factor that determines whether an activity is a trade or business is whether it is entered into with the dominant hope of making a profit.

The majority opinion noted that the Claims Court had based its conclusion on four factors that indicated ABE was not motivated by "profit" - at least not in a commercial sense. These included: (1) the program had been devised as a means of fund raising and had been so presented from its inception; (2) the program's success was evidence that it was noncommercial and that it depended on the generosity of its members; (3) the fund raising aspect of the program was voluntary because the members could collectively change its terms if they chose to do so; (4) since ABE did not underwrite insurance or act as a broker, it was not unfairly competing with commercial entities.

The Supreme Court disagreed with the Claims Court's view that the "enormous" dividends generated by ABE's program could not constitute "profits". The majority opinion observed that ABE priced insurance premiums so that they would be competitive with commercial insurance rates. The Court argued that the activity might appear more like a fund raising event if ABE charged more than commercial rates. Under such circumstances, one could "plausibly believe" that the surplus was due to generosity. (Looked at another way, the Court was saying that it could not find the intention to make a gift where "donors" were paying the market price.)

The Court addressed (2), above, by pointing out that there could be reasons other than generosity that explained ABE's success. For example, the majority argued, ABE's success could be explained by its monopoly on access to its membership.

The Court disagreed with the Claims Court's finding that the program was voluntary. It noted that if ABE were to give each member participating in the program a choice as to whether ABE could retain the dividends, the argument for voluntariness would be "more convincing".

The Court concluded that the Claims Court erred in finding that ABE's program did not present the potential for unfair competition. It argued that commercial competitors would be at a double disadvantage because: (1) if members could deduct dividends, insurance could be sold at less than commercial rates, and (2) as a tax exempt organization ABE had one less item of cost than its commercial competitors. The Court noted that ABE was the kind of organizations the Congress had in mind when it enacted the UBIT provisions.

### C. Charitable Contributions

The IRC 170 issue in ABE resulted from the consolidation of a lawsuit for a refund brought by individual members of ABE, in which they argued that a charitable deduction should be allowed for the dividend portion of their premium payments.

The Court approached the issue of whether ABE's members had made a donation to the organization as part of their premium payments by applying the two-part test set forth in Rev. Rul. 67-246, 1967-2 C.B. 104. Under this "dual character" test, a contribution is only deductible if it exceeds the fair market value of the goods or services received and if the donor intends that the excess be a gift. Any transaction

that involves a payment for goods, services, or other item of value gives rise to a presumption that the payment equals the fair market value of the goods or services. Thus, in order to use dual characterization as a basis for a partial deduction, the price must be above fair market value of the item in question and the difference between the payment and the market value must be intended as a gift.

After applying the two-part test of Rev. Rul. 67-246, the Court found that three of the four contributors had not established that they could have purchased the insurance for less. While the fourth contributor produced evidence that there was a group program that cost less, he failed to demonstrate that he was aware that he was paying more than he needed to pay and that the overpayment was intentional when he participated in ABE's program. Therefore, none of the contributors could establish the requisite intent to make a gift and the deductions were disallowed.

#### D. The Implications of ABE

A critical factor in the Supreme Court's thinking when it was analyzing the intentions of parties in ABE was pricing. Where market price is paid, the Court found that it was not evident that a purchaser intends to make a contribution. Indeed, it is clear under ABE and Rev. Rul. 67-246 that in "dual character" situations, organizations must charge more than fair market value in order for a contributor to be able to show the intention to make a gift.

On the other hand, if the issue is whether an activity is a trade or business for purposes of IRC 162, the question is whether an activity is entered into with the intention of making a profit. Where an organization prices the item above market (and, in most instances, this also means above cost), it would seem hard to argue that the organization does not intend to make a profit. (Presumably, there could be rare, mostly temporary circumstances where the cost of an item was greater than its market value, but even in these the issue would be whether there was an intention to make a profit over the long haul.)

For an organization, proving that it both intends a marketing situation to provide deductible contributions for its patrons, and, at the same time, that it does not intend to make a profit is virtually impossible. This evidentiary catch 22 that confronts organizations involved in marketing programs seems to have had an impact on how these organizations structure their programs, for example, in PLR 8725056. That ruling involved an insurance program, where returning the dividend was made optional. The Service ruled that, since there was no longer a mandatory "donation" in order to participate in the insurance program, the income from the dividends that

were turned over would not be considered UBI and the members would be permitted to take a charitable deduction under IRC 170 for the donations.

#### 4. Mailing Lists

##### A. Mailing Lists - the Disabled American Veterans Litigation

IRC 513(h)(1)(B) of the Code provides that unrelated trade or business income does not include the exchange or rental of lists of the names of donors or members between exempt organizations contributions to which are deductible under IRC 170(c)(2) or (3).

That provision was enacted by Congress as part of the Tax Reform Act of 1986 (Section 1601 of Pub. L. 99-514) as a result of the ruling in Disabled American Veterans v. U.S., 227 Ct.Cl. 474, 650 F.2d 1178 (Ct. Cl. 1981) (DAV I). DAV I held that income from the rental or exchange of donor mailing lists, in connection with its solicitations program, during the years 1970 through 1973 constituted unrelated business income. DAV rented its mailing list to exempt and commercial entities. The Court rejected the argument that the income from rental of mailing lists was related because DAV was unable to show that dealings with exempt organizations enhanced DAV's own fund raising efforts. The Court also rejected DAV's argument that the income constituted a royalty. (Royalty income is excluded from unrelated business taxable income under IRC 512(b)(2)) In the Court's view, rather than being income from passive activity, the income generated from DAV's mailing was from a business activity. DAV was conducting its mailing list rental program through commercial brokers, it was providing specialized lists, on different mediums much as any commercial renter would. Therefore, the income generated was not a royalty under IRC 512(b)(2), instead the income from rentals to both exempt organizations and commercial entities was subject to taxation as unrelated business income under IRC 511-513 of the Code. (For an overview of the royalties issue, see CPE 1989, Page 31).

In DAV II (Disabled American Veterans v. U.S., 94 T.C. 60 (1990), reversed 942 F.2d 309 (6th Cir. 1991), DAV challenged the IRS' tax deficiency claim for the same program during the years 1974 through 1985. The Tax Court rejected the government's argument that collateral estoppel prevented the re-addressing of the royalties issue, holding that the income from the rental of the mailing lists to exempt and nonexempt entities constituted royalties. DAV had argued that the issuance of Rev. Rul. 81-178, 1981-2 C.B. 135, contained principles that were not discussed by the Court of Claims in DAV I, and the Tax Court found that the "change in the legal

climate" warranted the Tax Court's reconsideration. (Rev. Rul. 81-178, in fact, continued to make a distinction between "active" and "passive" activity.

In reaching its conclusion, the Court, in DAV II, noted that IRC 512(b)(2) did not make a distinction between income from active and passive activities the way that other Code sections such as IRC 543(a)(1)(C) and IRC 954(c)(2) do. Thus, in the Court's view, IRC 512(b)(2) excluded any payment for the right to use an intangible asset.

DAV II was appealed and in its majority decision, the 6th Circuit Court of Appeals held that the Tax Court had erred and that DAV was collaterally estopped from bringing the action. Citing NCAA v. Commissioner of Internal Revenue, 92 T.C. 456 (1989), rev'd on other grounds, 914 F. 2d. (10th Cir. 1990); Illinois State Troopers v. Commissioner of Internal Revenue, 833 F. 2d 717 (7th Cir. 1987); and National Water Well Association v. Commissioner 92 T.C. 75 (1989) the Appeals Court reasoned that Rev. Rul. 81-178 did not change the legal climate since the courts still interpreted it as requiring the active - passive distinction.

Technically, the appeal of DAV II was decided on the issue of collateral estoppel. This means that the Tax Court's opinion DAV II remains as the last pronouncement of that court on the interpretation of IRC 512(b)(2). There is considerable doubt, however, that the Tax Court would continue to take the position that it did in DAV II were the issue to come before it again. (See the discussion of the Sierra Club litigation, infra.)

There are two factors that lead to this conclusion. One is that the majority opinion in the 6th Circuit signaled, although they did not decide the case on the issue, that, if the question was before them on the merits, they would recognize the active-passive distinction.

Second, Circuit Judge Martin, in his concurring opinion cited IRC 513(h)(1)(B) as settling the issue of whether DAV's income from mailing lists constituted royalties. He stated that the fact that Congress, in enacting IRC 513(h)(1)(B), applied the exemption from UBIT specifically to the rental or leasing of mailing lists between exempt organizations, was evidence that Congress agreed with the conclusion in DAV I insofar as it held that such arrangements by an exempt organization with commercial entities gave rise to UBI. Therefore, to accept the view of DAV, or the Tax Court for that matter, that revenue from mailing lists constitutes royalties, regardless of whether the activity was active or passive, would "totally eviscerate" the negative inference of IRC 513(h)(1)(B) that rentals to nonexempt

organizations should be taxed as UBI. DAV II 942 F. 2d at 317 (J. Martin, Concurring).

#### B. Mailing Lists - The Negative Inference of IRC 513(h)(1)(B)

The scope of the Service's reading of IRC 513(h)(1)(B) was first enunciated in G.C.M. 39638 (Nov. 17, 1985). After reviewing the legislative history, Counsel concluded, "We believe that the conclusion is inescapable that Congress ... acquiesced in the taxation of mailing list income not covered by section 1601 of the Act."

In August of 1987, the Service issued PLR 8747066 which involved a domestic fraternal organization described in IRC 501(c)(10). Under that facts, the fraternal organization entered into an agreement with a bank which permitted the bank to solicit the fraternal organization's members for participation in a credit card program. Also under the agreement, the fraternal organization agreed to provide the bank with up-to-date mailing lists. In return, the fraternal organization received payment when a member joined the program and when a credit card was renewed.

The PLR held that the income received by the fraternal organization from the bank was royalty income. (Presumably the holding was based on the active-passive distinction under IRC 512(b)(2), although the facts certainly suggest that the fraternal organization must have been actively involved in perfecting its mailing lists.)

Almost as soon as it was issued, the PLR was reconsidered and in PLR 8823109 the Service reversed its holding. The new PLR was based on G.C.M. 39727 (Jan. 25, 1987). G.C.M. 39727 observed that "... the royalty exception under [IRC] 512(b)(2) is not applicable to this case. Rather, because the activity concerns the receipt of income from a third-party's use of an exempt organization's membership lists, the resolution of the issue is governed solely by [IRC] 513(h)(1)(B)." (emphasis added)

The use of the term "third-party" was deliberate. The IRC 513(h)(1)(B) applies to organizations described in IRC 170(2) and (3). Since the organization discussed in PLR 8747066 and G.C.M. 39727 was not described in those two subsections, the G.C.M. was applying the negative inference argument to all third-party transactions involving mailing lists - whether with IRC 170(c)(2) and (3) organizations or not.

### C. The Reach of The Negative Inference Argument

The negative inference argument was invoked again in G.C.M. 39827. This G.C.M. involved an organization exempt under IRC 501(c)(3). that received income for the lease of its membership mailing list and the licensing of its name and logo by a commercial insurance company for the purpose of promoting a group insurance plan for the its members. The organization claimed that rental of its mailing list was inseparable from the licensing agreement for the use of its name and logo. Therefore, it interpreted IRC 512(b)(2) as applying, not only to the income from the licensing agreement, but also to the income from rental of the mailing lists.

The G.C.M. concluded that the payments made to the organization by the insurance company were consideration for services performed rather than royalties. Despite the organization's argument that it did not perform any services, several aspects of the arrangement were interpreted as services in the G.C.M. Besides providing access to its mailing list, the organization agreed to deal with one insurance company exclusively, reserved the right to approve the insurance offered to its members, to set the terms and conditions of the plans, and to approve any modifications. Based on Rev. Rul. 81-178, 1981-2 C.B. 135 and National Water Well Ass'n v. Commissioner, 92 T.C. 7 (1989), the organization's extensive involvement in the provision of group insurance to its members was not passive in character, but rather, constituted the performance of personal services. Therefore, the payments were payment for services rather than royalties.

The G.C.M. also attributed the activities of the insurance company to the organization based on an agency theory, because of the significant control over the plan exerted by the organization.

Although it was not crucial to the outcome of the case, the G.C.M. also concluded that payments for use of the organization's name and logo were inseparable from the payments for rental of the organization's membership list. Thus, both parts of the arrangement were governed by IRC 513(h)(1)(B). The G.C.M. argues that the reason for this interpretation is that the payments for use of the name and logo are contingent upon the organization's making its membership list available to the insurance company.

## D. Allocation Issues

There is, at least, one issue involving the allocation of expenses that is present in most of the mailing list cases. It involves the deductibility of expenses incurred in maintaining a mailing list.

IRC 512(a)(1) provides that "unrelated business taxable income" is defined as "gross income derived by any organization from any unrelated trade or business less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business..."

Regs. 1.512(a)-1(a) provides that an item of expense must be proximately and primarily related to the carrying on of that business in order to be deemed "directly connected".

Regs. 1.512(a)-1(b) provides that expenses, depreciation and similar items attributable solely to the conduct of the unrelated trade or business activities are proximately and primarily related to that business activity and, therefore, are deductible to the extent that they meet the requirements of IRC 162.

Reg. 1.512(a)-1(c) provides for a reasonable allocation of expenses, depreciation and similar items where facilities (or personnel) are used for both an exempt activity and an unrelated trade or business.

Reg. 1.512(a)-1(d) provides that where gross income is derived from an unrelated trade or business activity that exploits an exempt activity, "expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income." Reg. 1.512(a)-1(d)(2) contains an exception to this rule for situations where: (i) the aggregate of expenses depreciation and other items exceeds the income attributable to the exempt activity; and (ii) the allocation of such excess to the unrelated trade or business activity does not result in a loss from the unrelated trade or business activity.

The example in Regs. 1.512(a)-1(e) is somewhat helpful in trying to decide whether the sale of a mailing list involves the dual use of facilities (Reg. 1.512(a)-1(c)) or exploitation of an exempt function (Reg. 1.512(a)-1(d)). The example involves W, an exempt business league, that agreed with an advertising agency to mail advertising materials to its members for a fee. In the example, the costs of attributable solely to the unrelated business activity such as the costs of handling and mailing the advertising material are deductible. The costs attributable allocable to

dual uses such as for personnel used to carry on both the exempt activity and the unrelated activity are deductible if they are reasonably allocated. However, the costs of maintaining W's membership and carrying on exempt activities are not deductible, since they are expenses of the exempt activity being exploited.

There is a sentence in the example, however, that suggests that maintenance of the membership is an exempt function being "exploited." If this is the case, there seems to be a significant question of whether exempt function expenses that exceed exempt function income may be deducted under the rule in Reg. 1.512(a)1(d)(2).

#### 5. The Future of Mailing List Questions and The Negative Inference Argument - The Sierra Club Litigation

Questions regarding the application of IRC 513(h)(1)(B) could receive their clearest test in the pending case Sierra Club v. Commissioner, Docket No. 8650-91, to be heard in the Tax Court some time this year. Clearly, this case should also resolve the question of the Tax Court's view on the proper interpretation of IRC 512(b)(2).

Sierra Club, which is recognized as exempt under IRC 501(c)(4) of the Code, rents its donor mailing list to both exempt and commercial organizations through a list broker. In addition to maintaining the list for its own purposes, Sierra Club approves the list rentals and administers the financial aspect of the program. As is the practice in the industry Sierra Club puts dummy names in the lists that it rents to protect against unauthorized use of the lists that it rents. Sierra Club also paid third-party contractors for processing the lists for prospective purchasers.

Sierra Club has also entered into an agreement with a bank card company for the marketing of credit or affinity cards to its members and with a bank for issuance of the cards. Under the agreement, Sierra Club agreed to cooperate with the bank card company in soliciting members to utilize credit cards bearing Sierra Club's name and logo. All costs of materials used in the solicitation programs was to be borne by the bank card company. Sierra Club, however, retained the right to approve of the content of these programs.

A percentage of the fee paid by a member for each use of the card is collected by the bank card company and a portion of that fee was passed on to Sierra Club. Such amounts are calculated as a set percentage of "Total Cardholder Sales Volume". Any annual fee charged by the bank to the cardholders is paid by the bank card company. Throughout the agreement between Sierra Club and the bank card

company, the various amounts to be paid to Sierra Club are designated as "royalties". Under the contract, Sierra Club's duties include selection of the card issuing bank, approval of any use of its name and logo on promotional materials, and choosing an option to pay production and mailing costs associated with the marketing of the card. Although a donor mailing list was provided to the bank card company to facilitate the marketing of the cards to members, Sierra Club is not required to do so under the agreement.

At this point, both the petition and the answer have been filed in the Sierra Club litigation.

## 6. United States Postal Regulations Relating to Eligibility Requirements For The Special Rates For Nonprofits

### A. Introduction

In 1975, the Postal Service adopted limitations on the use of the bulk third-class postage rate otherwise available to exempt organizations for so-called "cooperative mailings". Those organizations eligible for the special rates include those exempt under IRC 501(c)(3) as a religious, educational, scientific, or charitable organization; 501(c)(5) agricultural or labor organizations; 501(c)(8) fraternal organizations; and 501(c)(19) veterans' organizations. Section 625.5 of the Domestic Mail Manual prohibits an organization from lending its special rate permit to a for-profit or mailing materials on behalf of or produced for a commercial organization. In spite of this limitation, cooperative mailing arrangements between nonprofits and commercial organizations subsequently increased due to the popularity of joint marketing ventures as revenue raisers. As a result, a substantial amount of promotional material marketing commercial services, such as affinity cards, travel tours, and insurance programs, has been sent at the bulk third-class rate rather than the regular commercial rate. In response, the Postal Service proposed an outright ban on the use of special rates by nonprofits for mailings that advertised products or services of commercial organizations.

Rather than adopting the total ban, Congress enacted new legislation limiting the use of the special rate as part of the Postal Service Appropriations Act for 1991. The new law became effective on February 3, 1991. The Postal Service adopted regulations to implement the legislation, in Section 625.522-.527 of the Domestic Mail Manual, effective September 13, 1991. In addition, the Postal Service has proposed rules for the interpretation of certain language in the new regulations.

## B. Mailing Restrictions in the Domestic Mail Manual

The new regulations prohibit the use of nonprofit mailing rates for materials that advertise, promote, offer, or for a fee or consideration, recommend, describe, or announce the availability of the following:

1. Affinity cards provided through or with a commercial entity;
2. Any insurance policy, unless it is promoted by a nonprofit organization that is eligible for the special rates; the policy is designed for that organization's members, donors, supporters, or beneficiaries; and the coverage provided by the policy is not generally otherwise commercially available.
3. Any travel tour, unless it is promoted by an eligible nonprofit organization; the travel contributes substantially (aside from the cultivation of members, donors, or supporters, or the production of income or funds) to one or more of the purposes which constitute the organization's eligibility for the special rates; and the tour is designed for and primarily promoted to the members, donors, supporters, or beneficiaries of that organization.

Finally, the regulations include new provisions for collection of revenue deficiencies, the furnishing of evidence to the Postal Service for rulings on eligibility to use of special rates, and additional appeal procedures.

## C. Definition of "Not Generally Commercially Available"

The Postal Service, on December 6, 1991, instituted a proposed rulemaking to interpret the definition of the term "not generally otherwise commercially available" in the section of the regulations restricting the use of special bulk rates for cooperative mailings to promote insurance. The proposed rule sets forth factors which the Postal Service suggests are relevant to a determination of whether an insurance policy is commercially available.

Under these rules, the terms of a marketed insurance policy, such as scope of coverage, limitations, and exclusions, would be analyzed. Also relevant would be the availability of coverage to the targeted category of mailing recipients, based on geographical or demographic restrictions. Under the rules, insurance that is not otherwise available to the specific demographic group targeted or that is not available

to that group in the targeted mailing area would qualify as "not generally otherwise commercially available". The proposed rule provides that certain factors are not appropriate to determinations of commercial availability. These include price of the policy, financial condition of the insurer, or underwriting, promotional, marketing or distribution practices. The test suggested in the proposed rule for determining commercial availability is "whether the targeted individuals may obtain that coverage from any other source, such as by the purchase of an individual policy or participation in a group policy through another organization".

Finally, the proposed rule suggests that certain lines of insurance should be considered as generally commercially available. These include life, automobile, airplane, travel, accidental death and dismemberment, homeowner's, property, casualty, and marine insurance. Others that the Postal Service may designate as commercially available in the final rule include medicare supplement (medigap), catastrophic care, health, truck, motorhome, motorbike, motorcycle, boat, nursing home, professional liability (including malpractice), and hospital indemnity insurance. It should be noted that the proposed rule states that the above list is not exhaustive and that other lines of insurance may be added in the future.

The impact of an organization offering a type of insurance included in the above list is that a strong presumption will be created that the insurance is commercially available. The organization would be given the opportunity to rebut the presumption by showing, using the cited test and relevant factors above, that the insurance at issue is not commercially available to the target group to which it is offered. The comment period for this proposed rule closed April 6, 1992. As of the date of publication of this article, the final rule had not been issued.

#### D. New Restrictions and Unrelated Business Income

One of the objectives that Postal Service seeks with these restrictions is to prevent commercial organizations that are engaged in joint marketing ventures with nonprofits from achieving a competitive advantage over other commercial organizations through more favorable bulk mailing rates. This is, in many ways, similar to the policy concerns that led to the enactment of the UBIT provisions. Both the Postal Service's restrictions and the UBIT provisions are intended to limit unfair competition.

Either as a result of or in spite of their similar objectives, a mailing that violates the Postal regulations will frequently result in income that is unrelated business taxable income under IRC 511-513 of the Code. For example, travel tours

that do not meet the Postal regulations, will not meet the requirements of Rev. Rul 78-43, supra. Similarly, insurance that is "commercially available" is likely to be "commercial-type insurance" for purposes of 501(m). ("Commercial-type insurance", however, is clearly a more inclusive term.)

It is yet to be seen whether the Postal Service's new content restrictions on cooperatives mailings will substantially limit future ventures between nonprofits and commercial organizations for marketing of affinity cards, travel tours, and insurance programs. For the present, the National Office is exploring the potential in these restrictions for compliance programs.