

G. LIMITED MEMBER DUES AS UNRELATED BUSINESS INCOME

by

Sadie Copeland and Gerald V. Sack

1. Introduction

The large membership base of some tax-exempt organizations represents an intangible asset that is readily marketable and potentially profitable to the organization. For example, group insurance is a particularly popular and profitable unrelated activity for membership-based exempt organizations. Individuals who are interested primarily in obtaining insurance rather than active membership may be required to join as associate or limited members and pay "dues" in order to obtain the insurance. In TAM 94-16-002 (Dec. 20, 1993), discussed below, the Service determined that such dues were payments for insurance and subject to the unrelated business income tax. In addition to insurance, other products and services may be offered by exempt organizations to their members. Whether income from these products and services is taxable as unrelated business income will depend on all the facts and circumstances. For example, in TAM 93-45-004 (June 27, 1993) also discussed below, the Service determined that dues from "patron members" were payments for advertising and subject to the unrelated business income tax.

This article explores the issues involved in determining the circumstances under which the so-called dues received from associate or limited benefit members may constitute unrelated trade or business income under IRC 512(a)(1) of the Internal Revenue Code, subject to tax under IRC 511.

2. Background

Generally, exempt membership organizations are supported by annual membership fees or dues. When these fees or dues are paid by all members in general support of an organization's exempt purposes and activities, the fees and dues income is related to the organization's exempt purposes and is exempt from tax.

Exempt membership organizations frequently provide their members with products and services that are unrelated to the purposes for which they are recognized as exempt. Income from providing such products and services is taxable as unrelated business income. For example, group insurance is a

particularly popular and profitable unrelated activity for many membership based exempt organizations especially for many of these exempt under sections 501(c)(5) and 501(c)(6). For such organizations income derived from providing insurance is subject to the unrelated business income tax. This issue has been reviewed in numerous CPE articles, most recently in the 1993 CPE beginning at page 62.

Where the product or service is marketed beyond an organization's regular members, there is an obvious incentive to characterize income from the sale of the product or service as nontaxable membership income. Accordingly, individuals who are interested in obtaining a product or service through the exempt membership organization, but otherwise are not interested in the organization's purposes or activities, may be required to join as a member and pay a membership fee in order to obtain access to the product or service.

Although the exempt organization may want the additional income from providing unrelated products or services, it may also want to restrict its membership to those truly interested and active in its cause or purposes. Thus, in marketing its unrelated products and services beyond its normal membership, the exempt organization may offer or require associate membership or some other type of limited membership for those primarily interested in purchasing the unrelated product or service.

These circumstances raise the question whether associate member fees and dues should be attributable to taxable unrelated activities.

3. Statutory Framework

Associate or limited membership dues may be subject to unrelated business income tax if they fall within the statutory framework of IRC 511-513. That is, there must first exist an activity that constitutes an unrelated trade or business such as providing insurance, advertising or some other service or product. Only then would an issue be raised concerning the possible taxation of associate or limited membership dues.

IRC 511(a) of the Code provides for the taxation of unrelated business taxable income of organizations described in IRC 501(c).

Before an activity may be taxed as unrelated business income, the following three conditions must be satisfied: (1) the activity must constitute a trade or

business; (2) the trade or business must be regularly carried on; and (3) the trade or business must not be substantially related to the organization's exempt purpose. See IRC 512(a)(1), 513(a).

The term "trade or business" generally includes any activity carried on for the production of income. See Reg. 1.513-1(b). A trade or business will ordinarily be considered "regularly carried on" if it manifests a frequency and continuity, and is pursued in a manner generally similar to comparable commercial activities of nonexempt organizations. See Reg. 1.513-1(c)(1).

Whether an activity is substantially related requires an examination of the relationship between the business activity that generates the income and the accomplishment of the organization's exempt purpose. To be "related" to exempt purposes, the conduct of the business activity must have a substantial causal relationship to exempt purposes. 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).

4. Prior Technical Advice Memoranda

In 1983, the Service ruled in two technical advice memoranda (TAMs 83-02-009 (Sept. 29, 1982) and 83-02-010 (Sept. 29, 1982)) that though the income from insurance activities conducted by the exempt organizations was taxable, the associate member dues were not taxable because there was no identifiable nexus to that portion of non earmarked dues allocable to the insurance programs. In each case, the local and state farm bureau had two classes of membership. Regular membership was open to individuals who operated a farm. Associate membership was open to anyone who could not become a regular member. According to the facts in each case, all regular and associate members paid the same annual dues. A portion of each dues payment to the local farm bureau was forwarded to the state farm bureau association.

In both cases, the Service found that associate members received benefits other than the right to participate in the insurance programs, including various publications, educational lectures and seminars and legislative representation on issues of concern to members. The Service concluded that these benefits indicated that the dues paid by associate members provided more than the right to participate in insurance programs and thus were not taxable as unrelated business income.

It is important to note that neither TAM considered the circumstances and manner in which associate members became members nor their actual interest and participation in the organization's activities beyond their insurance programs.

In recent TAMs the Service has expanded its consideration of the facts and determined that unrelated business income tax may be imposed on amounts such as dues or fees received by an exempt membership organization that provides unrelated products or services to individuals who are not "regular" members. The TAMs are consistent with recent circuit level decisions in American Postal Workers Union, AFL-CIO v. United States, 925 F.2d 480 (D.C. Cir. 1991), and National Association of Postal Supervisors v. United States, 944 F. 2d 859 (Fed. Cir. 1991), which hold that dues from associate union members are taxable where the members joined the unions and paid dues primarily to obtain lower cost group insurance.

5. TAM 94-16-002

The issue of whether associate member dues paid to an IRC 501(c)(5) agricultural organization are taxable as unrelated business income was addressed in TAM 94-16-002.

In this case, an exempt agricultural organization has two classes of members. Regular membership is open to persons engaged in the production of agricultural or horticultural products, or persons who have been members for five consecutive years immediately prior to retiring from farming and who maintain their dues. Associate membership is open to persons interested in agriculture. Associate members are entitled to the rights of membership except that they do not have the right to vote or serve as directors or voting delegates at annual meetings. Associate members may be officers and committee members.

In addition to activities that promote agriculture, the organization offers automobile, life and health insurance programs through a taxable subsidiary. Membership is required to participate in some, but not all, insurance plans.

In determining whether associate member dues constituted unrelated business income, the Service compared the requirements for membership in both classes. The Service found that associate members do not appear to be bona fide members in a manner similar to regular members. Associate members cannot vote, represent their counties as voting delegates at annual meetings or serve on the board of directors. Although associate members may serve as officers, those

associate members who are officers are also full-time employees of the organization. The Service noted that the presence of employees of the organization as associate members and officers appears to be a matter of operational convenience and is not indicative of bona fide participation by associate members.

The TAM noted that the organization conducted a survey that indicated that accessibility to insurance programs offered by the organization was the major reason that associate members joined. The organization could not or would not provide actual figures concerning associate member participation in either insurance or non-insurance related activities. Consequently, the TAM concluded that the income received in the form of associate membership dues is primarily for insurance and thus taxable as unrelated business income.

6. TAM 93-45-004

In TAM 93-45-004, the Service found that annual dues received by an IRC 501(c)(6) trade association from supplier companies classified as "patron members" were advertising payments subject to unrelated business income tax.

In this case, the organization holds educational programs and trade shows, publishes a membership list, a special buyers guide, and a quarterly journal. There are several classes of members, including professional members and firms that supply services and products to the professional members (patron members).

The benefits patron members receive include (1) being listed in each quarterly issue of the journal; (2) a free copy of the quarterly journal, (3) a detailed listing in an annual publication containing a description of the types of products manufactured or other services offered by the patron members (4) a free copy of the membership roster; (5) the right to submit "news" articles for the quarterly publications and (6) the right to submit more detailed articles for a special annual issue which generally discusses products and includes pictures and brand identification.

The Service found that patron members were allowed to promote their products in association publications. The Service found that since the patron members and their products are identified in the special issue and various publications, the patrons are purchasing direct access to the professional members of the organization and are attempting to influence the direction in which the professionals will be spending their client's money. The Service concluded that this is the "essence of advertising" and income derived from advertising activity is

taxable as unrelated business income.

The Service examined the benefits received by the patrons in connection with the dues paid. The Service found that other than being able to advertise, the patron members receive little or no other benefits for their membership in the organization. In addition, the Service found that the various rights of the patron members are restricted when compared with those of the professional members and that patron members have virtually no control over operations of the organization. Therefore, patron members are not "bona fide" members and the entire amount of the membership dues received from patron members constitutes unrelated business income.

7. Who is a Bona Fide Member?

A major consideration in both TAMs is whether associate members are "bona fide" members in a manner similar to other members or whether they joined the association to obtain benefits that are not substantially related to the organization's purposes. If members are "bona fide" members, then the money collected from them constitutes regular dues and is not income from an unrelated trade or business. If associate members are not "bona fide" members, then the money collected from them constitutes income from providing products or services and may be taxed as unrelated business income.

Several attempts have been made by the courts and federal agencies to define the term "member".

For example, in American Postal Workers Union, AFL-CIO v. United States, *supra*, the circuit court held that a labor union's role in the sponsorship of a health insurance plan for associate members, who were members for the sole purpose of participating in the health plan, constitutes the conduct of an unrelated trade or business subject to the tax imposed by IRC 511(a). The court found that associate members could not vote or seek office. Nor were they represented by the union in collective bargaining, grievance procedures and arbitration. Associate members received no privilege other than access to the health plan and the court concluded that the "dues" received by the union constitute unrelated business taxable income. See also, National Association of Postal Supervisors v. United States, *supra*.

In National Association of Life Underwriters, Inc. v. Commissioner, 64 CCH Tax Ct. Mem. 379 (1992) the court looked at the cases cited above for

guidance in determining whether individuals were members of an association within the meaning of section 1.512(a)-1(f) of the regulations regarding the treatment of advertising income as unrelated business income. The court, in concluding that certain individuals were not members, found that the purported "members" had no right to participate in the organization's direction; nor did they have the obligation to help support the organization through regular financial contributions; nor did they constitute members in the organization's articles of incorporation and by-laws.

Likewise, in three nontax cases, the courts have discussed the status of "members" of an organization.

In Hunt v. Washington Apple Advertising Commission, 432 U.S. 333 (1977), the Supreme Court of the United States held that a state promotional organization, which did not technically have members, had standing to bring an action on behalf of the state's apple growers. In reaching that conclusion the Court found that although the apple growers and dealers were not "members" of the Washington Apple Advertising Commission, they possess all of the indicia of membership in an organization. They alone elect the members of the commission; they alone may serve on the commission; they alone finance its activities, including the costs of litigation, through assessments levied upon them. In a very real sense, therefore, the commission represents the state's growers and dealers and provides the means by which they express their collective views and protect their collective interests.

Similarly, in Health Research Group v. Kennedy, 82 F.R.D. 21 (1979), Judge John Sirica applied the membership indicia in Hunt v. Washington Apple Advertising Commission, *supra*, to determine whether a nonmembership public interest group had standing to represent the interests of over-the-counter drug consumers in a suit against the Food and Drug Administration. The court found that since the financial contributors had no rights in selecting directors or formulating policy, they could not be considered members of the organization, even for purposes of giving that organization standing to represent them.

Also, in FEC v. National Right to Work Committee, 459 U.S. 197 (1982), the U.S. Supreme Court examined whether persons who responded to solicitation by the National Right to Work Committee constituted members for purposes of the Federal Election Campaign Act, 2 U.S.C. sec. 441b(b)(4)(C). In holding that the persons solicited did not qualify as members, the Court found that the purported "members" played no part in the operation or administration of the corporation;

they elected no corporate officials, and participated in no meetings. Also, the "members" did not exercise control over the expenditure of their contributions.

Subsequent to the National Right to Work Committee decision, the FEC issued final regulations providing that "members" means all persons who currently satisfy the requirements for membership in a membership association, affirmatively accept the membership association's invitation to become a member, and either:

- (1) Have some significant financial attachment to the membership association, such as a significant investment or ownership stake (but not merely the payment of dues);
- (2) Are required to pay on a regular basis a specific amount of dues that is predetermined by the association and are entitled to vote directly either for at least one member who has full participatory and voting rights on the highest governing body, or for those who select at least one member of those on the highest governing body of the membership association;
- (3) Are entitled to vote directly for all of those on the highest governing body of the membership association; or
- (4) The Commission may determine, on a case by case basis, that persons seeking to be considered members of a membership association have a significant organizational and financial attachment to the association under circumstances that do not precisely meet the general rule. See 11 C.F.R. 114.1(e).

Unlike the FEC, the Service has not and is not now considering similar rules for defining "members". Rather, as in the above court cases, the Service will consider all the facts and circumstances in determining "bona fide" membership.

8. Conclusion

Decisions are still evolving as to what income, especially dues income, is taxable because it is attributable to unrelated activities. Relevant facts for consideration include the rights and benefits provided to regular and associate members and how the organization and its benefits services are marketed to regular and associate members. In determining whether tax treatment should apply

to dues paid by an associate member or any similar limited member, all the facts and circumstances of the particular case should be considered.