Uniform Issue List
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INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

Area Manager

Taxpayer's Name:

Taxpayer's Address:

Employer Identification Number:

Years Involved: Taxable Years Ending December 31, 1996
and December 31, 1997

No Conference Held

Legend:

M =
N =
O =
P =
x =

Issues:

Whether M, which is tax exempt under section 501(c)(6) of the Internal Revenue Code, receives unrelated business taxable income under section 512(a)(1) from an advertising program, as described below.

Facts:

The members of M are local publishers who publish newspapers and shoppers circulated free of charge to households in a particular geographic area. M's ostensible purpose is to promote the free paper industry in a certain State through education in marketing programs. M is supported by members' dues and revenues from a contract with N for advertising published by M's members in their newspapers and shoppers.

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M entered into an agreement with N as a means of funding member benefits. N is a division of O, which does business nationwide and reaches over 50 million households throughout the 50 States. M and its members have never provided services for any other organization similar to N.

M assists its members and others in the industry through a variety of programs. It organizes educational conferences four times a year. M publishes a monthly newsletter for its members. It also presents awards for achievements in such fields as art, photography, news coverage, editorials, and community services.

For the two tax years in question, M received approximately $94x and $109x, respectively, from the advertising network program. The necessary work to administer the program is carried out by N (a for-profit entity that sells direct advertising to customers) and the member publishers and their employees. The two organizations have been in a contractual relationship for an eight-year period.

The program operates as follows: N receives advertisements that are to be placed in members' newspapers. N types, assembles, and photocopies the advertisements for a mailing, which is sent weekly to M's members. The mailing usually consists of anywhere from 10 to 15 ads per week. Your office has determined that N devoted 7 to 10 hours per week to this activity. Based on information that we received from M, N's involvement accounts for somewhat less than one-fourth of the total time spent on the activity.

Upon receipt of the mailing, each member newspaper must lay out and typeset each ad for publication in its newspaper. This requires from 30 to 45 minutes per week for each member publisher. M advised us that 56 members (out of a total of 65) participated in the N program in 1996 and 52 members (out of 57) participated in 1997. Thus, the combined time of participating members is approximately 34 hours per week (averaging members' program participation in the two years and averaging 30 and 45 minutes per week). Accordingly, member publishers expend over three-fourths of the time needed to complete this advertising endeavor. The individual member publishers do not receive any fees for their services and for the ads in their free papers. However, M and N each receives a commission of 50% of net advertising proceeds from this program. If a member publisher solicits an ad on its own, it is entitled to keep 55% of the ad revenues, but it is also required to send the remaining 45% to N, which in turn will send 25% of the total sale to M and keep the remaining 20% for itself. This understanding is memorialized in the Working Agreement dated January 4, 1999 (Exhibit 9-B).

Exhibit 9-C consists of eight pages of ads from the Sunday, March 7, 1999, edition of the P Area Shopper. It runs the full gamut, including services offered by small businesses, houses and automobiles for sale, employment opportunities, financial services, lost and found, etc.

Law:

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. For this relationship to exist, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends, in each case, upon the facts and circumstances involved.

Section 512(b)(13) of the Code provides that if an organization (the "controlling organization") receives (directly or indirectly) a specified payment from another entity which it controls (the "controlled entity"), then the controlling organization shall include such payment as an item of gross income derived from an unrelated trade or business to the extent such payment reduces the net unrelated income of the controlled entity (or increases any net unrelated net loss of the controlled entity). There shall be allowed all deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence.

Rev. Rul. 82-139, 1982-2 C.B. 108, holds that the publication of ordinary commercial advertising for products and services used by the legal profession in a bar association's journal is unrelated trade or business under section 513 of the Code. However, the publication of legal notices is not unrelated trade or business under section 513 because its purpose is to inform the general public of significant legal events rather than to stimulate demand for the products or services of an advertiser.

In United States v. American College of Physicians, 106 S. Ct. 159 (1986), the Supreme Court held that advertising in the journal of the American College of Physicians ("ACP") does not contribute importantly to the organization's educational purposes and therefore is subject to tax pursuant to the provisions of sections 511-513 of the Code.

ACP is tax exempt under section 501(c)(3) of the Code. Its membership is limited to members of the medical profession engaged in practice, teaching, research and other pursuits in the field of internal medicine or in allied or related specialties. ACP publishes a journal called the Annals of Internal Medicine. The journal contains scholarly articles in the field of internal medicine, advertisements of medical products, supplies, and equipment useful in the practice of internal medicine, and notices of positions desired or available.

Advertisements were "stacked" at the front and behind the editorial content of each issue, as is also the custom with medical journals published by commercial organizations. Advertising space was made available at rates competitive with those charged by commercial organizations for advertising space in their medical journals. ACP's policy is to accept only those advertisements relating to medical products (primarily drugs), supplies, and equipment useful in the practice of internal medicine. Preferred advertisements are screened for accuracy and relevance to internal medicine.

The Court held that the journal advertising was unrelated to the organization's educational purposes. However, the Supreme Court rejected the blanket per se rule advanced by the Government, i.e., the position that advertising published by tax-exempt professional journals can never be substantially related to their purpose. As stated by the Court:

> This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury. (Our emphasis).

A case that closely followed the holding in American College of Physicians is Florida Trucking Association v. Commissioner, 87 T.C. 1039 (1986), (CCH Dec. 43,485). The court held that the sale of advertising in a trade association's journal was not "substantially related" to the organization's exempt purposes where it consisted merely of ordinary commercial advertising, and no formal effort was undertaken by the publication to relate the advertising sale program to the organization's purposes.

For federal income tax purposes, a parent corporation and its subsidiaries are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with a bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, 431 F.2d at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 488 F.2d 1098, 1106 (5th Cir. 1973).

From the above cases, as well as others that could be cited, it is clear that the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent. This is an evidentiary burden that is difficult to overcome.

In determining whether or not an agency relationship exists between designated parties, we have to look at all the relevant facts and circumstances. "An essential characteristic of an agency relationship is that the agent acts subject to the principal's direction and control." See In re Shulman Trans. Enters., Inc., 744 F.2d 293, 295 (2nd Cir. 1984). The manner in which the parties to an agreement designate their relationship is not controlling. See Board of Trade v. Hammond Elevator Co., 198 U.S. 424, 437 (1905).

In State Police Association of Massachusetts v. Commissioner, 125 F.3d 1 (1st Cir. 1997), the court determined that the independent contractors retained by the Association, a labor organization tax exempt under section 501(c)(5) of the Code, were agents of the Association because they were under its control for purposes of the particular transaction. The contractors were retained to publish a yearbook and recruit telemarketers. The court found that the Association exercised tight control over the method and manner of solicitation, the ingredients of the sales pitch, the identity of the solicitors, financial aspects of the arrangement, the use of its name, advertising formats, and the contents of the yearbook. Therefore, the activities of the contractors were attributable to the Association, and its earnings were subject to the tax imposed by section 511.

Rationale:

It is clear that the ads placed in the newspapers and shoppers of M's member publishers are of an ordinary commercial nature. They do not meet the stringent standards for relatedness to exempt purposes set forth in American College of Physicians and related cases. Further, this advertising activity is regularly carried on within the meaning of section 512(a)(1) of the Code

inasmuch as it is conducted on a weekly basis throughout the year. Thus, if the advertising activity was conducted by M, or could be attributed to it, then the net income that M received from this activity would be subject to the tax imposed under section 511. However, based on all the available information, we have concluded otherwise, as explained below.

The individual publisher members of M are not in any sense subsidiaries of M. They are clearly not "controlled entities" within the meaning of section 512(b)(13) of the Code. Each of these members carries on its own independent business activities. See the holding in the cases of Moline Properties, Inc. and Britt, both cited above.

In addition, all the facts and circumstances here point to the finding that the publisher members are not acting as agents of M. There is no indication whatsoever that they are subject to the control or direction of M. They participate in the advertising program in question of their own free will. There is no evidence of any pressure or coercion on M's part to induce its members to participate in the program. And, in point of fact, nine members did not participate in 1996, and five members did not participate in 1997. Further, there is no indication that these members were penalized in any way for their non-participation.

N cannot be considered an agent of M with respect to the advertising program. While M shares in the revenues from the program, it does not control the manner in which N goes about the conduct of the ad program. The situation here is in marked contrast to that presented in the case of State Police Association of Massachusetts, supra, where, with respect to publication of a yearbook, the exempt organization retained very tight control over the method and manner of solicitation by telemarketers, the substance of the sales pitch, the identity of solicitors, financial aspects of the arrangement, use of its name, advertising formats, and finally, the contents of the yearbook.

Based on the foregoing, we conclude that the advertising placed in M's members' publications pursuant to its contract with N is not an activity which is conducted by M, nor can it be considered an indirect activity on the basis of any theory of agency or attribution. In our view, the amounts in question are in the nature of additional dues payments to M from its members.

Conclusion:

M does not receive any unrelated business taxable income under section 512(a)(1) of the Code from the newspaper advertising program described above because it does not conduct the activity nor can the activities of its member publishers or the commercial broker, N, in connection with this program be attributed to M on the basis of any agency relationship.

M may wish to advise its members that the amounts in question are not taxable to M.

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Further, M's members may wish to consider whether they should treat such amounts as part of their taxable income.

A copy of this memorandum is to be given to the organization. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent

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