BARNES & THORNBURG LLP

IRS HOT TOPICS

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A. Independent Contractor

1. IRS Authority On Independent Contractor Status

The IRS has focused for the last decade on the status of individuals as employees or independent contractors. This is a focus which has been highlighted in yearly announcements of top issues to be reviewed during an IRS audit. From our firm's experience, we find that field auditors are indeed focusing on any individual names listed on 1099s and reviewing the facts and circumstances to determine whether those individuals should be treated as employees.

In the past, the IRS focused on 20 factors which might indicate employee or independent contractor status. This focus has shifted to control by the payor over the actions of the individual. The fundamental question is who retains the right to determine the means and method by which a task is accomplished.

Other factors retain relevance. For example, the ability to require an individual to undertake a task is a sign that the individual is an employee. The association's obligation to pay any required assistants is a sign of employee status. The ability of the individual to make more or less money, based on the individual's control of expenses, is a factor which indicates contractor status.

Another factor of importance to the Internal Revenue Service is whether the individual's services are an integral part of the association. For this reason, we recommend that contractors, such as publication editors not be included as such in the governance structure of the association to preserve independent contractor status. They are outside service providers: they should not be part of the internal management. The selection of contractors should appear like the selection of any other vendors for the association to preserve independent contractor status.

The payment of expenses of the independent contractor by the association tends to indicate that the individual is actually an employee. If this is the only factor working against the characterization as an independent contractor, it should be not be fatal. The more types of expenses paid, however, the more likely it is that the individual will be treated as an employee. For example, paying for home office expenses is a factor which may make the IRS consider the individual to be an employee.

2. Officers as Employees

Corporate officers are specifically included with the definition of an employee under FICA, FUTA, and federal income tax withholding purposes. See IRC 3121(d)(1), IRC 3306(i), and IRC 3401(c).

The IRS field auditors have been particularly harsh on officer compensation. The IRS position is that the board controls the officers, which is true under the law of most states.

3. The Contract

A good contract confirming independence factors will help confirm to the IRS on audit that the contractor is actually an independent contractor for tax payers and not an employee and will also be useful in preventing assessments by state authorities.

The contract should be labeled as an independent contractor agreement. Provisions such as the following should be included:

- The contractor acknowledges and agrees that he or she is an independent contractor.
- The contractor retains the right to determine the means and method by which the services are rendered.
- The non-profit retains control only over the result to be accomplished.
- Any assistants which the contractor requires will be paid solely by the Editor and will not be considered contractors or employees of the Association for any purpose.
- The non-profit will have no obligation or liability to Editor or any other party for worker's compensation, federal and state payroll taxes, unemployment taxes, minimum wages, social security assessments or similar taxes, benefits or liabilities.
- The contractor is not eligible to participate in any benefits available to employees of the Association.

- The contractor shall also have no authority to bind the Association to any contract or agreement.

B. Corporate Sponsorships

For the last decade, corporate sponsorship income has been the subject of scrutiny by the Internal Revenue Service and Congress. The IRS recognized that non-profits were earning significant revenue from corporate sponsorship, and issued guidelines which would have made virtually all corporate sponsorship income taxable. Thanks to some quick and effective lobbying on the part of charities, the Internal Revenue Service changed its position and issued regulations which make many types of corporate sponsorship income tax-free. The regulations were codified in 1997. By following a few simple rules, a non-profit has great flexibility in accepting tax-free corporate sponsorship revenue.

1. Definition of Corporate Sponsorship.

Corporate sponsorship is financial support by an outside party, usually a corporation, for the good works of a non-profit organization. It is distinguished from a charitable contribution in that a corporate sponsor is typically motivated by a desire to receive a public acknowledgment in exchange for its support. For example, the cereal companies that pay the Olympics Committee for the right to put “Official Sponsor of the Olympics” on their products would be treated as corporate sponsors rather than charitable donors.

2. Basic Rules

The law permits a non-profit to receive corporate sponsorship income tax-free if what is given the corporate sponsor in return for its payment is an acknowledgment of thanks. This acknowledgment can take a variety of forms. The non-profit can hang a banner in its headquarters, or in the room where the sponsored event is taking place. It can take space in a conference program to thank the sponsor, or the staff or volunteer leaders can stand at a podium and thank the corporate sponsor. The acknowledgment of thanks can list the corporate sponsor’s name, logo, address, telephone number, and products. The corporate sponsor can distribute samples of its products at the sponsored event. In short, the law places few restrictions on the format of the acknowledgment of thanks.

3. Prohibitions

There are, however, two important prohibitions. First, the non-profit cannot make a qualitative judgment on the corporate sponsor's products or services. This means that acknowledgments of thanks should not contain comparative language or language that implies good quality. Words like "best", "finest", "top-notch service", and the like must be eliminated from any copy which will be included in an acknowledgment of thanks for a tax-free payment. This can usually best be achieved if the non-profit writes the acknowledgment of thanks, rather than permitting the corporate sponsor to write its own copy.

The second prohibition is that the non-profit cannot ask its members or the public to buy the products or services of the corporate sponsor. Even an innocent phrase like "please patronize our sponsors" would jeopardize the tax-free nature of the corporate sponsorship payment.

4. Endorsements

One item which a non-profit may not provide without allocating a portion of its revenue as taxable income is an endorsement. An endorsement would be considered as a request for members of the public to buy the product or service of the corporate sponsor. Endorsements also carry product liability, public relations, and other risks. Many non-profits use the taxability of corporate sponsorship income when exchanged for an endorsement as a good reason to tell their corporate sponsors that providing an endorsement of the product or service is simply out of the question.

5. Periodicals

The 1997 codification of the corporate sponsorship law contained a troublesome addition. It states that, if the acknowledgment of thanks were contained in a periodical which was not published in connection with a sponsored event, the corporate sponsorship payment would not qualify for tax-free treatment. This seems even less logical than the typical Internal Revenue Code provision. Why prohibit acknowledgments in periodicals, when such great flexibility is otherwise permitted? Recent pronouncements show that the IRS is rethinking this point and more flexible guidance may be issued in the future. In the meantime, acknowledgments in periodicals should be tied to some special event, like a sponsored conference or educational program. For example, "we wish to thank the following companies, which are providing corporate support for our upcoming conference ..." might be published in a special conference edition of a newsletter.

6. Allocations

The 1997 law added a very helpful aspect of flexibility to the rules. If a non-profit violates one of the rules, the entire corporate sponsorship payment will not necessarily be taxable. Only a portion would be taxable, which is fairly allocable to the value of the taxable benefit provided to the sponsor. For example, if a non-profit received a $10,000 sponsorship payment in return for a banner at the sponsored event and a half-page ad in the conference program, only a portion of the $10,000 would be taxable. That portion would be determined by the fair market value of the half-page ad, which may be easy to value based on how much other advertisers paid for similar space.

If the non-profit knows at the time the deal is struck that a portion of the payment will be taxable income, but the value is not easy to estimate, it may wish to consider valuing that item in the contract or other written agreement with the corporate sponsor, to avoid having the IRS later assign too great a value to that portion of the consideration.

7. Substantial Return Benefits

Regulations issued in 2000 defined "substantial return benefits." To the extent of the value of a sponsor's substantial return benefit, the sponsorship payment will not be exempt from UBIT.

A substantial return benefit is "any benefit other than goods, services, or other benefits of insubstantial value" received by the sponsor in consideration of its payment. For example, if a sponsor receives free advertising, certain facilities or privileges such as complimentary event tickets or products, the sponsor may have received a substantial benefit return. The exempt organization must pay tax on a portion of the sponsorship payment, measured by the fair market value of the substantial return benefit, but only if benefit would produce taxable income if sold separately. For example, including a free exhibit booth in a conference sponsorship would not result in taxable income, because exhibit booth rental is not taxable income.

8. Exclusivity

The regulations make a distinction between exclusive sponsorship arrangements and exclusive provider arrangements. In an exclusive sponsorship arrangement, the exempt organization acknowledges the sponsor as the exclusive sponsor of a specific activity. These arrangements generally do not create a substantial return benefit. If the organization promises to buy products in a category only from the sponsor, the portion of the sponsorship payment allocable to this benefit is taxable.

9. Web Sites

The regulations state that a non-profit may thank its corporate sponsor on its web site and link to the corporate sponsor's home page without allocating a portion of the corporate sponsorship revenue to taxable income.

Corporate sponsorship has become big business for non-profits. Large and small non-profits alike are seeking and receiving significant revenue from companies that want to have their names associated with the good works of the non-profit organizations. By attending to a few details up-front and keeping the basic rules in mind, non-profits can avoid paying tax on their corporate sponsorship revenue and keep more dollars in their coffers to carry on their educational, charitable, professional, and other non-profit programs.

C. Royalties

1. Tax on Unrelated Business Income

Sections 511 through 513 impose a tax on the unrelated business taxable income of a tax-exempt organization.

- UBI is income derived from a trade or business, regularly carried on, that is not substantially related to the organization's tax-exempt purpose, less related deductions. Secs. 512 (a)(1), 513(a).

2. Modifications

Section 512(b)(2) modifies section 512(a) and provides:

- There shall be excluded [from UBI] all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

3. Regulations

The regulations generally refer to "royalty" as income derived from the disposition or use of mineral rights.

4. Rev. Rul. 81-178

In Rev. Rul. 81-178, a 501(c)(5) organization of professional athletes received proceeds from licensing the use of the organization's "trademarks, trade names, service marks, copyrights, and members' names, photographs, likenesses, and facsimile signatures in connection with the distribution, sale, advertising, and promotion of merchandise or services.

- The organization had the right to approve the "quality or style of the licensed products and services."
- The licensees, which were commercial organizations, agreed to refrain from any activities that would affect adversely the organization or its members, or the value of the licensed products or services.
- The licensees paid the organization either a percentage of gross sales or a flat sum.

Applying the general rule that a royalty is a payment for the right to use an intangible asset, the ruling concluded that the payments under the licensing agreements were royalties and, therefore, were excludable from UBI pursuant to section 512. Rev. Rul. 81-178.

- The fact that the organization retained the right to approve quality or style was immaterial to respondent's conclusion. Also immaterial was the fact that the exempt organization's transactions were with commercial businesses.

- If an agreement also required personal appearances by the members of the organization, however, the ruling concluded that the payments were compensation for personal services and were not royalties.

5. Statutory Construction

As a matter of statutory construction, identical words used in different parts of the Internal Revenue Code are normally given the same meaning.

6. Narrow Definition of Royalties

The IRS takes the position that, notwithstanding Rev. Rul. 81-178, "royalty" for purposes of section 512(b)(2) has a different and narrower meaning than for other provisions of the Code because of the different policies underlying the rules for tax-exempt organizations.

- The IRS relies on Congress' intention to tax an exempt organization when it competes with taxpaying commercial organizations.

7. DAV I

In *Disabled Am. Veterans v. United States*, 227 Ct. Cl. 474, the exempt organization engaged in the rental of its mailing list, but, the organization itself performed all of the list management and list fulfillment functions.

- On the question of whether the list rental payments were royalties, the court of Claims concluded that the list rentals "[were] the product of extensive business activity by DAV and [did] not fit within the types of `passive' income set forth in section 512(b)."
- The court found that the payments were more akin to rent from the use of personal property than to royalties, and held that the income from the transaction was not excluded from UBI under section 512(b).

8. DAVI II

In *Disabled Am. Veterans v. Commissioner*, 94 T.C. 60, 76 (1990), the same exempt organization that appeared before the court of Claims in DAV I appeared before the Tax Court; however, a different taxable year was in issue. Although DAV II involved the same parties and legal issues as DAV I, the Tax Court concluded that the issuance of Rev. Rul. 81-178, had changed the legal climate.

- The Tax Court held that collateral estoppel did not apply. Relying on the definition of royalty contained in Rev. Rul. 81-178, supra, the Tax Court concluded that there is no distinction between active and passive royalties for section 512(b)(2) purposes. It also made it clear that it could distinguish payments for the use of an intangible, which constitute a royalty, from payments for advertising, compensation for services, or other profits masquerading as royalties.

- The Court of Appeals for the Sixth Circuit, reversing the decision of the Tax Court, held that the issuance of Rev. Rul. 81-178, supra, was not a sufficient change of legal climate to preclude collateral estoppel.

9. Sierra Club

In *Sierra Club, Inc. v. Commissioner*, T.C. Memo. 1993-199, the Sierra Club did not itself perform any of the list management or list fulfillment functions. A professional list manager performed all list management functions, and a computer house performed all list fulfillment functions.

- The Tax Court held that the payment received by the exempt organization was, at least in part, a royalty. It rejected the Commissioner's argument that royalties, in the context of section 512(b)(2), meant only those earned passively.

- The Tax Court also held, however, that an issue of fact existed regarding whether any part of the list rental transaction price, specifically the fees for special selections, media, and shipping, was payment for goods and services. Before appeal, the parties in Sierra Club settled the issue of whether any part of the list rental payment was for goods or substantial services provided in connection with the rental transactions.

- The Court of Appeals for the Ninth Circuit held that the term "royalty", as it is used in section 512(b)(2), "is by definition `passive' and thus cannot include compensation for services rendered by the owner of property." *Sierra Club Inc. v. Commissioner*, 86 F.3d at 1532.

- Additionally, the court reasoned that, because the exempt organization did not itself provide any services to the mailer, the entire amount it actually received was a royalty for UBI purposes.

10. Additional Tax Court Cases

The Tax Court has continued to allow royalty treatment for mailing list rentals and affinity credit card programs.

- In *Common Cause v. Commissioner*, 112 T.C. 332 (1999), income of social welfare organization from rental of its mailing list excluded as royalties.

- In *Planned Parenthood Federation of America, Inc. v. Commissioner*, T.C. Memo 1999-206, income of charitable organization from rental of its mailing list excluded as royalties.

11. Publishing Royalties

In *Arkansas State Police Association, Inc., v. Commissioner*, 282 F.3d 556 (8th Cir. 2002), the court considered whether payments received by an association from the publisher of the association's magazine derived from advertising revenue in the association's magazine should be treated as taxable unrelated business income or as nontaxable royalty income.

- The association argued that the income it derived from the magazine was a royalty and thus nontaxable income, since the association's participation in the publication was passive and only related to the protection of its name.

- The court rejected the association's arguments and ruled that the publisher's payments were taxable.

- The court also found that the association retained control over the publisher's content and so the association's behavior was not passive.

D. Net Operating Losses

1. Definitions

Simply stated, an NOL is the excess of allowable deductions over gross income, computer under the law in effect for the loss year, with the required adjustments. Generally, net operating losses can be carried back to the two years preceding the loss year and then forward to the 20 years following the loss year.

2. Profit Motive

If a trade or business conducted by an exempt organization governed by Section 512(a)(1) lacks profit motive or any other requirement of a trade or business under Section 513, it does not meet the Section 512(a)(1) requirement, and it cannot be an unrelated business activity. If it is not an unrelated business activity under Section 512(a)(1), it is by definition an exempt activity not subject to tax. If an activity is an exempt activity, the expenses from such activity may not be used to offset net income from unrelated business activities. An activity qualifies as a "trade or business" capable of generating deductions under Section 162 only if the

taxpayer engaged in the activity with the intention of making a profit. Most importantly, the intent to make a profit must be the taxpayer's primary reason for engaging in the trade or business activity.

The general rule under the Code is that losses incurred in a profit-seeking venture may be deducted but expenses of a not-for-profit activity may be offset against the income of that activity, but losses may not be applied against income from other sources. As stated above, in *National Association of Life Underwriters, Inc. v. Commissioner of Internal Revenue*, T.C.M. 1992-442, the court held that even though an exempt organization may continuously and regularly engage in an unrelated activity, losses from the activity may not be used to offset unrelated business taxable income if the unrelated activity was not entered into primarily for profit. Similarly, in *Portland Golf Club v. Commissioner*, the Tax Court reasoned that, in order to prove that the club had an intent to profit in its activities, the club must establish that for each year in issue, the club intended to earn net income, gross income exceeding both the direct an indirect expense, from these activities. Because of the series of losses being reported by the club on their tax returns, the Tax Court concluded that the club did not have the intended profit motive and disallowed the losses from its nonmember activities as an offset against the club's investment income.