Case Comments

Advertising and the Unrelated Business Income Tax After *United States v. American College of Physicians*

I. Introduction

Since the late 1940s, Congress and the Treasury Department have been concerned with the expansion of the business activities of tax-exempt organizations. The evolution and growth of the tax law in this area corresponds with the increasing efforts by tax-exempt organizations to generate more funds to meet their financial needs.[1]

As tax-exempt organizations[2] struggled to obtain the scarce inflow of funds available from the private and public sectors, these organizations found it necessary to reach out and tap other sources of income.[3] Commercial enterprises, which found themselves competing with these tax-exempt organizations, cried out for help from the federal government.[4] Congress responded in 1950 by enacting sections 511 through 514 of the Internal Revenue Code (Code), which tax exempt organizations on their unrelated business income.[5] Sections 511 through 514 and the accompanying Treasury regulations have evolved over the years to keep pace with the ever broadening scope of the involvement of tax-exempt organizations in commercial activities. Both the courts and the Internal Revenue Service (Service) have been forced to rule on an endless stream of factual situations, each presenting a distinct challenge to the flexibility of the Code and Treasury regulations. The United States Supreme Court recently addressed certain issues concerning these activities when it decided the case of *United States v. American College of Physicians*.[6]

The purpose of this Case Comment is to trace the path of the unrelated business income tax (UBIT) as it affects the advertising activities of tax-exempt organizations, from its inception in 1950 to the Supreme Court's decision in *American College*. This Case Comment first lays out the three major tests involved in determining whether a UBIT is due: the "trade or business" test,[7] the "regularly carried on" test,[8] and the

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1. United States v. American College of Physicians, 475 U.S. 834, 837–38 (1986).

2. Congress has given certain organizations an exempt status from federal taxation. I.R.C. § 501 (West Supp. 1987). A partial list of exempt organizations includes entities organized exclusively for religious, charitable, scientific, literary, or educational purposes.

3. Tax-exempt organizations have entered the commercial markets, conducting activities which generate substantial amounts of income that can then be used to further their tax-exempt purpose. *See generally* Donahue, *Unrelated Business Income of Tax Exempt Organizations*, 37 N.Y.U. Ann. Inst. on Fed. Tax'n § 27.01 (1979); *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 18–19 (1950) [hereinafter *Hearings*] (statement of John W. Snyder, Sec. of the Treasury).

4. Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 Harv. L. Rev. 1280, 1281 (1968) [hereinafter *Macaroni Monopoly*].

5. I.R.C. §§ 511–514 (West Supp. 1987).

6. 475 U.S. 834 (1986).

7. *See* I.R.C. § 513(a) (West Supp. 1987); Treas. Reg. § 1.513-1(b) (1967). *See infra* notes 32–36 and accompanying text.

8. *See* I.R.C. § 512(a) (West Supp. 1987); Treas. Reg. § 1.513-1(c) (1967). *See infra* notes 37–41 and accompanying text.

"substantially related" test.[9] This Case Comment then analyzes the impact of the Supreme Court's decision in *American College*[10] and discusses methods that taxpayers like the American College of Physicians can utilize to avoid paying the UBIT.[11]

Finally, this Case Comment proposes two changes in the tax laws relating to the advertising activities of certain exempt organizations.[12] First, Congress should clarify the "substantially related" test by explicitly stating in the Code that in order for an activity to be "substantially related," the *primary* purpose in carrying on the activity must be to contribute importantly to the organization's exempt purpose. This change would provide better guidelines to assist exempt organizations in structuring their advertising activities, while also providing the judiciary with a more workable standard.

Second, Congress should provide a special exemption for continuing education journals within the medical profession. This new provision would exempt from the imposition of the UBIT income generated from advertisements that relate to the educational function of a medical journal. This change would assist the medical profession in its quest to continually educate its members by keeping the cost of these journals as low as possible.

II. History

A. *Prior to the UBIT*

Prior to 1950, there was no statutory provision to deal with the income that tax-exempt organizations derived from commercial activities. Courts confronted with this issue imposed no tax on this income if the organization used the funds generated by the commercial activity in furtherance of its exempt purpose.[13] This judicial policy, referred to as the "destination of income" test,[14] looked at the use of the funds, not their source. In response to this policy, numerous tax-exempt organizations began carrying on commercial activities in direct competition with corporations whose activities were taxed. A glaring example of an exempt organization entering a commercial market was depicted in *C.F. Mueller Co. v. Commissioner*.[15] Through the purchase of the C.F. Mueller Co., New York University became the largest noodle manufacturer in the world.[16]

9. *See* I.R.C. § 513(a) (West Supp. 1987); Treas. Reg. § 1.513-1(d) (1967). *See infra* notes 42–48 and accompanying text.

10. 475 U.S. 834 (1986); *see infra* notes 84–87 and accompanying text.

11. *See infra* notes 88–93 and accompanying text.

12. *See infra* notes 96–118 and accompanying text.

13. Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924).

14. *Id.* at 582.

15. 190 F.2d 120 (3d Cir. 1951).

16. New York University organized a tax-exempt corporation for the purpose of benefiting its law school. This tax-exempt corporation then purchased all of the stock of the C.F. Mueller Co., a taxable corporation engaged in the manufacture of macaroni. The United States Court of Appeals for the Third Circuit stated that as long as the object of the

In response to the perceived abuses, the Secretary of the Treasury criticized the test's focus on the destination of the funds in his testimony before the House Committee on Ways and Means stating:

> The law has been interpreted by some courts to attach the exemption to the destination of the income rather than its source. [This treatment has allowed] some colleges and other institutions [to engage] in a wide variety of business undertakings, including the production of such items as automobile parts, chinaware, and food products, and the operation of theaters, oil wells, and cotton gins.[17]

B. *The Birth and Development of the UBIT*

After holding hearings, Congress decided not to disturb the tax-exempt status of these organizations.[18] Instead, it chose to impose a tax on the income generated from activities that are not substantially related to the organization's exempt purpose.[19] The Treasury Department has stated that the purpose of the UBIT is to "eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."[20] Congress could have imposed a tax upon the income derived from all commercial activities, but instead chose a more moderate approach, balancing the need for tax-exempt organizations to generate funds with the need to curb the unfair advantage these organizations had over nonexempt entities.

From the inception of the UBIT until 1967, the Treasury Department considered only integrated commercial activities[21] as a trade or business. Under this approach, advertising activities of tax-exempt organizations that published periodicals did not fall within the definition of a trade or business, and thus, were not subject to the UBIT. In 1967, the Treasury Department issued new regulations interpreting the definition of a "trade or business."[22] These regulations redefined "trade or business" to include not only integrated businesses, but also components of the overall organization.[23]

The 1967 regulations also attempted to clarify the "substantially related" test,[24] adding that the conduct of the activity must have a "causal relationship" to the organization's exempt purpose.[25] For an activity to have such a causal relationship,

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tax-exempt organization continues to be charitable, the method of obtaining the necessary funds is irrelevant. *Id.* at 124. *See also Macaroni Monopoly supra* note 4, at 1280.

17. *Hearings, supra* note 3, at 19.

18. United States v. American College of Physicians, 475 U.S. 834, 838 (1986).

19. I.R.C. § 511 (West Supp. 1987).

20. Treas. Reg. § 1.513-1(b) (1967).

21. *See* Hopkins & Kaplan, *Could Ditunno and Hoopengarner Result in Expanding the Scope of Unrelated Business?*, 60 J. TAX'N 40, 40–41 (1984).

22. Treas. Reg. § 1.513-1(b) (1967).

23. This new approach, which first appeared in 1967, is often referred to as "fragmenting" the activities of an enterprise. *See* United States v. American College of Physicians, 475 U.S. 834, 839 (1986). These regulations were originally held invalid as contravening the intent of Congress. *See* American College of Physicians v. United States, 530 F.2d 930 (Ct. Cl. 1976); Massachusetts Medical Soc'y v. United States, 514 F.2d 153 (1st Cir. 1975). Congress validated the Treasury Department's "fragmentation" approach when it passed the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969). *See* I.R.C. § 513(c) (West Supp. 1987).

24. *See* I.R.C. § 513(a) (West Supp. 1987).

25. Treas. Reg. § 1.513-1(d)(2) (1967).

"the production or distribution of the goods or the performance of the services . . . must contribute importantly to the accomplishment of [the exempt] purposes."[26]

Section 513(c) of the Code was enacted as part of the Tax Reform Act of 1969 to deal with the advertising activities of exempt organizations.[27] This legislation also broadened the coverage of the UBIT by applying it to organizations such as churches, associations of churches, and social clubs, all of which had originally been exempt.[28]

III. Mechanics of the UBIT

The first step in imposing the UBIT is to determine which tax-exempt organizations are subject to this tax.[29] After it is established that the UBIT applies to an exempt organization, it must be shown that the organization earned "unrelated business taxable income." "Unrelated business taxable income" is defined as the "gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business. . . ."[30] Generally excluded from this definition are dividends, interest, rents from real property, and royalties.[31]

There are three aspects to the definition of unrelated business taxable income. First, the exempt organization must be involved in a "trade or business."[32] A "trade or business" is defined as "any activity carried on for the production of income from the sale of goods or the performance of services."[33] In order for an activity to be considered a "trade or business," it must compete in some fashion with similar activities of taxable organizations.[34]

The definition of "trade or business" is not limited to integrated activities that comprise an entire organization's function. Congress has stated that activities carried on within the entire operation of an exempt organization do not lose their identity as a "trade or business."[35] This "fragmentation" approach has been applied to many activities, including advertising in an exempt organization's journal and sales of pharmaceuticals to the general public by an exempt hospital.[36]

26. *Id.*

27. I.R.C. § 513(c) (West Supp. 1987), which states: "[A]n activity does not lose identity as a trade or business merely because it is carried on . . . within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."

28. *See* I.R.C. § 511(a)(2)(A) (West Supp. 1987).

29. I.R.C. § 511(a)(2) (West Supp. 1987) (organizations subject to the tax include any organization that is exempt from taxation by reason of I.R.C. § 501); *see supra* note 2.

30. I.R.C. § 512(a)(1), (3) (West Supp. 1987). The phrase "this chapter" refers to chapter 1 (normal taxes and surtaxes) of the Code.

31. I.R.C. § 512(b)(1)–(3) (West Supp. 1987).

32. I.R.C. §§ 511, 512(a)(1) (West Supp. 1987).

33. Treas. Reg. § 1.513-1(b) (1967).

34. *Id.*

35. *Id.*

36. *Id.*

Second, the trade or business must be "regularly carried on" by the tax-exempt organization.[37] The Service will examine the frequency, continuity, and manner in which the activity is pursued and compare it to similar activities of taxable organizations.[38] The applicable Treasury regulation states that if the activity of a nonexempt organization is conducted on a year-round basis, the conduct of this activity for a few weeks by an exempt organization does not constitute a "regularly carried on" trade or business.[39] It proceeds to give as an example of such a situation the operation of a sandwich stand for two weeks at a state fair.[40] On the other hand, conducting a year-round business for one day each week or conducting an activity during a significant portion of a season would constitute the regular conduct of a trade or business.[41]

Third, there must be no substantial relation between the exempt organization's trade or business and its exempt purpose.[42] This is determined by examining the relationship between the business activity and the accomplishment of the organization's exempt purpose.[43] The activity is related "only where the conduct of the business activities has [a] causal relationship to the achievement of [the] exempt purposes. . . ."[44] For the activities to be substantially related, "the production or distribution of the goods or the performance of the services . . . must contribute importantly to the accomplishment of [the exempt] purposes."[45] Whether or not the activities contribute importantly "depends in each case upon the facts and circumstances involved."[46]

The size and extent of the activity is an important consideration in applying the "substantially related" test.[47] When an activity is conducted on a scale larger than reasonably necessary to accomplish the purported function, the income attributable to the excess activity constitutes unrelated business income.[48]

IV. *United States v. American College of Physicians*

The Supreme Court's decision in *United States v. American College of Physicians*[49] analyzed the "substantially related" test as it applies to the advertising activities of tax-exempt organizations. The case arose out of the following facts. The American College of Physicians (College) is a tax-exempt organization under section

37. I.R.C. § 512(a)(1) (West Supp. 1987).
38. Treas. Reg. § 1.513-1(c)(1) (1967).
39. *Id.* § 1.513-1(c)(2)(i).
40. *Id.*
41. *Id.*
42. I.R.C. § 513(a) (West Supp. 1987).
43. Treas. Reg. § 1.513-1(d)(1) (1967).
44. *Id.* § 1.513-1(d)(2).
45. *Id.*
46. *Id.* See also Treas. Reg. § 1.513-1(d)(4)(i), examples 1–3 and § 1.513-1(d)(4)(iv), examples 1–7 (1967) for helpful applications of the "substantially related" test to fact patterns.
47. Treas. Reg. § 1.513-1(d)(3) (1967).
48. *Id. See also* Iowa State Univ. of Science & Technology v. United States, 500 F.2d 508 (Ct. Cl. 1974) (holding that the university-owned television station was an unrelated business because the profit motive outweighed the educational aspects of the activity).
49. 475 U.S. 834 (1986).

501(c)(3) of the Code.[50] Its exempt purposes are "to maintain high standards in medical education and medical practice; to encourage research, especially in clinical medicine; and to foster measures for the prevention of disease and for the improvement of public health."[51]

The College publishes a journal entitled the *Annals of Internal Medicine* (*Annals*) to advance its exempt purposes. Each issue of the journal contains editorial articles pertaining to a wide spectrum of medical issues. *Annals* also contains advertisements for pharmaceuticals, medical products, supplies and equipment useful in the practice of internal medicine, and notices of positions available within the field.[52] The College accepts only those advertisements falling into these categories after screening for accuracy and relevance to internal medicine.

In 1975, *Annals* produced gross advertising income of $1,376,322, resulting in a UBIT of $55,965. The College reported this sum on its 1975 tax return and paid the tax. The College subsequently filed a timely claim for refund of these taxes, and upon the disallowance of this claim by the Service, the College filed suit in the United States Claims Court.[53]

A. *Decision of the Claims Court*

The Claims Court held that neither the conduct of the activities nor the advertisements themselves were substantially related to the College's tax-exempt purpose, and thus, the income was subject to the UBIT.[54] The correlation between the advertisements and the College's educational purpose was found to be incidental, because "the comprehensiveness and content of the advertising package is entirely dependent on each manufacturer's willingness to pay for space and the imagination of its advertising agency."[55] Advertisements were grouped in "stacks" appearing at the beginning and end of each issue.[56] The advertisements were not used to provide a comprehensive or systematic presentation of the goods or services, but were laid out in a "hit-or-miss" approach.[57] In order to avoid the UBIT, the court stated that the College would have to change the way it chose and presented its advertisements. The Claims Court suggested that the College try "to provide advertising that comprehensively surveys a particular field. . . ."[58] The Claims Court held that the College made no attempt to coordinate the advertisements with the editorial content.[59] The court admitted that all advertisements have some informational value, but said that "[t]o qualify for exemption, the advertising package as a whole must serve an identifiable

50. *Id.* at 836. The American College of Physicians is not a true college, in that students do not attend classes on a regular basis for the purpose of attaining a degree. The organization is made up of medical doctors who wish to keep current with the constant changes within their profession.

51. *Id.*

52. *Id.*

53. *Id.* at 836–37.

54. American College of Physicians v. United States, 3 Ct. Cl. 531, 535 (1983).

55. *Id.*

56. *Id.* at 533–34.

57. *Id.* at 534 n.3.

58. *Id.* at 535.

59. *Id.* at 534.

educational objective that goes substantially beyond the informational content of the individual advertisements.''[60]

B. *Decision of the Federal Circuit*

The Claims Court's finding that the College's advertising was not substantially related to its exempt purpose was held to be clearly erroneous by the United States Court of Appeals for the Federal Circuit.[61] The Federal Circuit stated that the Claims Court had incorrectly focused on the ''commercial character'' of the advertising and on the similarities between the advertising activities carried on by the College and the advertising activities carried on by nonexempt organizations.[62]

Also, the Federal Circuit decided that the Claims Court ''imposed a more rigorous standard'' than did the statutes.[63] The Claims Court's decision required that the College's advertising activities, as a whole, ''serve an identifiable educational objective that goes substantially beyond the informational content of the individual advertisements.''[64] According to the Federal Circuit, the correct inquiry was whether the advertisements contributed importantly to the educational purposes of the College.[65] The College had provided unrebutted testimony on the informative nature of the advertisements and the importance of such continuing education. Upon this evidence the court held that the College was able to show that its advertising activities were substantially related to its tax-exempt purposes.[66]

C. *Decision of the United States Supreme Court*

The United States Supreme Court granted certiorari and reversed the Federal Circuit, holding that the College received unrelated business income from its advertising.[67] The Supreme Court agreed with both of the lower courts that neither Congress nor the Treasury Department intended to establish a per se rule that commercial advertising in a tax-exempt journal could never be substantially related to the exempt organization's purpose.[68] The Court stated that the legislative history surrounding the Tax Reform Act of 1969 was too inconclusive to support an interpretation that Congress intended a per se rule taxing all advertising income of tax-exempt organizations.[69] Also, the Treasury Department's regulations, specifically section 1.513-1(d)(4)(iv), example 7,[70] were found to be too ambiguous to establish a sweeping per se rule.[71] Thus, under this holding, all cases involving

60. *Id.* at 534–35.
61. American College of Physicians v. United States, 743 F.2d 1570, 1577 (Fed. Cir. 1984).
62. *Id.* at 1575.
63. *Id.* at 1576; *see also* I.R.C. §§ 511, 513 (West Supp. 1987).
64. American College of Physicians v. United States, 743 F.2d 1570, 1577 (Fed. Cir. 1984).
65. *Id.* at 1576; *see also* Treas. Reg. § 1.513-1(d)(2) (1967).
66. American College of Physicians v. United States, 743 F.2d 1570, 1576 (Fed. Cir. 1984).
67. United States v. American College of Physicians, 475 U.S. 834, 849 (1986).
68. *Id.* at 847.
69. *Id.* at 846.
70. *See* Treas. Reg. § 1.513-1(d)(4)(iv), example 7 (1967).
71. United States v. American College of Physicians, 475 U.S. 834, 843 (1986).

advertising income of tax-exempt organizations will be decided individually, based upon the particular facts and circumstances in each case.[72]

After disposing of the per se rule, the Court dealt with the three specific requirements necessary to establish that an activity produces unrelated business income.[73] First, it found that the College's advertising activities constituted a separate "trade or business" as defined in the Code and Treasury regulations by using the "fragmentation" approach.[74] Congress added this "fragmentation" approach in 1969 in order to broaden the reach of the UBIT to include those activities that are components of a larger endeavor.[75] The Court held that the second condition of imposing the UBIT was met because the facts showed that the College "regularly carried on" the business of advertising in their publication of *Annals*.[76] The third prong, requiring a showing that the conduct of the trade or business does not substantially relate to the tax-exempt purpose of the organization, represented the "crux" of the dispute in the case.[77]

After reviewing the lower court opinions, the Court stated that the Claims Court's emphasis on the *conduct* of the College in choosing and presenting the advertisements was the correct approach.[78] In reversing the Federal Circuit, the Court stated that the circuit court had improperly focused on the "educational quality of the advertisements," and that a court's approach should not focus on the benefits that may be attained by the subscribers.[79] The correct approach is to discern whether the organization's advertising activities "reflect an intention to contribute importantly to its educational functions."[80]

Chief Justice Burger in his concurring opinion stated that the majority opinion reflected a "permissible reading of the present Treasury [R]egulations."[81] The Chief Justice, however, invited the legislature to enter the arena and change the rules to allow medical journals to publish all medical advertisements without the imposition of a tax. Chief Justice Burger recognized that income generated by organizations such as the College could then be used to reduce the cost of publishing continuing education journals, which would most likely increase circulation.[82] Burger stated that this result is desired because "[t]here is a public value in the widest possible circulation of [medical] data. . . ."[83]

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72. *Id.* at 847; *see also* Treas. Reg. § 1.513-1(d)(2) (1967).

73. United States v. American College of Physicians, 475 U.S. 834, 838–39 (1986). *See supra* notes 32–48 and accompanying text.

74. United States v. American College of Physicians, 475 U.S. 834, 839 (1986).

75. *See supra* notes 18–22, 32–36 and accompanying text.

76. United States v. American College of Physicians, 475 U.S. 834, 840 (1986); *see supra* notes 37–41 and accompanying text.

77. United States v. American College of Physicians, 475 U.S. 834, 840–41 (1986).

78. *Id.* at 848 (emphasis added).

79. *Id.*

80. *Id.* at 849.

81. *Id.* at 850 (Burger, C.J., concurring).

82. *Id.*

83. *Id.*

V. Impact of *United States v. American College of Physicians*

A. *Future Application*

From the definition of "unrelated trade or business" in section 513(a),[84] the Supreme Court could have utilized a standard that requires the *conduct* of the activity itself to serve the exempt purpose. If the Court had chosen this standard, only in rare situations would an activity such as the College's advertising satisfy this rigorous test.[85] Instead, the Court held that the proper inquiry is whether the College has performed or provided its services "in a manner that evinces an intention to use the advertisements for the purpose of contributing importantly to the educational value of the journal."[86]

This language could be viewed as articulating a subjective inquiry into the "intent" of the tax-exempt organization. The Court, however, is actually using an objective standard, examining the manner in which the tax-exempt organization conducts its commercial activities. If the College can show that the way it presents and chooses its advertisements reflects an intention to contribute importantly to its exempt purposes, then its advertising income will not be taxed. The proof comes from an objective examination of the conduct of the College's activities, not from the subjective intent or motives of the College's editors, officers, or directors. *American College* does not require courts to extensively examine every particular advertisement in order to determine whether the advertisement is actually contributing to the exempt purpose. The key is the manner in which the tax-exempt organization conducts its activities, not the quantum of benefits its users derive.

Yet the extent to which actual benefits are derived from an activity like advertising should not be entirely ignored. The Supreme Court stated that the Federal Circuit erred in focusing "exclusively upon the information that is invariably conveyed by commercial advertising. . . ."[87] Although the informational value of the advertisements is not the primary inquiry, the courts will undoubtedly require that the benefits of such advertisements be more than incidental. At a minimum, the advertisements will be required to relate to the exempt purpose of the publication. Thus, running an advertisement for a luxury automobile in *Annals* would not be considered related to the College's exempt purposes.

It is apparent that the Court is more interested in the exempt organization's overall presentation of its advertisements (*i.e.*, the conduct of the exempt organization) than in the educational quality of the advertisements. As long as the advertisement is related to the exempt function, a court will likely refrain from

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84. "The term 'unrelated trade or business' means . . . any trade or business the *conduct* of which is not substantially related . . . to the [exempt function]." I.R.C. § 513(a) (West Supp. 1987) (emphasis added). *See also* Huffaker & Gut, *Supreme Court Holds Advertising Revenue Was Not Substantially Related Income*, 65 J. Tax'n 2, 4 (1986) [hereinafter Huffaker & Gut].

85. Treas. Reg. § 1.513-1(d)(4)(iv), example 5 (1967) illustrates a situation in which an activity could satisfy this test. In the example, students at a university published a campus newspaper that included news, editorials, and paid advertising. The advertising is substantially related to the university's exempt purpose because the advertising business itself contributes importantly to the training of the students.

86. United States v. American College of Physicians, 475 U.S. 834, 848–49 (1986).

87. *Id.* at 850.

making a determination as to the actual educational value of each and every advertisement.

B. *Avoiding Imposition of the UBIT*

The College and similar organizations will undoubtedly look to *American College* for guidance in tailoring their advertising activities to avoid the UBIT. This decision will affect the types of advertisements these organizations choose, the content of these advertisements, and how they are presented.

The College could change its operations in the future "to reflect an intention to contribute importantly to its educational functions."[88] The Court gives two methods that the College could adopt: (1) publish only those advertisements relating to new and emerging medical products; and (2) coordinate the content of the advertisements to coincide with the editorial content.[89]

The first of these suggestions remedies a perceived flaw in the College's choice of advertisements. The Supreme Court agreed with the Claims Court's opinion that the College's decision to repeat advertisements for "established" drugs "undermin[ed] the suggestion that the advertising was principally designed to alert readers of recent developments. . . ."[90] It appears, therefore, that the College and similar organizations will no longer be able to derive untaxed income by running the same advertisements month after month. There will be a time when a specific drug is no longer considered a "new development." The courts may utilize an objective standard to determine when a certain drug is no longer a new development, perhaps when the "reasonable physician" would be aware of the drug. If these advertisements for "established" drugs are continued, they will reflect an intention that the College was not using the advertisements to contribute importantly to its exempt purposes, but instead to generate income.

The second suggestion offered by the Court is in response to the Claims Court's finding that the College was not using its advertisements to "provide its readers [with] a comprehensive or systematic presentation of [the materials]. . . ."[91] The College might be able to avoid the imposition of the UBIT if it matches the content of its advertisements with the content of its editorial articles.[92] For instance, if the College is publishing an article on the complications associated with ulcerative colitus, the College could run an advertisement relating to a new drug used to combat the disease. It is even possible that a pharmaceutical company would be willing to pay more for an advertisement appearing in close proximity to an article relating to its use. At a minimum, the College should attempt to place advertisements near a related editorial article, whether or not the advertisements are concerned with new developments.

88. *Id.* at 849.
89. *Id.* at 849–50.
90. *Id.* at 849 (quoting American College of Physicians v. United States, 3 Cl. Ct. 531, 534 (1983)).
91. American College of Physicians v. United States, 3 Cl. Ct. 531, 534 (1983).
92. United States v. American College of Physicians, 475 U.S. 834, 849 (1986).

Commentators have suggested that journals such as *Annals* utilize a table of contents to coordinate advertisements more closely with the editorial content.[93] Use of a table of contents would assist in illustrating the exempt organization's intention to present its advertisements in a comprehensive manner while also enhancing the educational value of the advertisements. On the other side, instituting the use of a table of contents along with the other proposed changes would create more work for the exempt organizations, which would likely increase the cost of publishing exempt journals. It is evident that these exempt organizations will need to be more conscientious in the selection and display of their advertising in order to avoid the imposition of the UBIT.

C. *Effect on Educational Value of Exempt Organization Advertising*

American College may be a windfall for journal subscribers. At first it would appear that exempt organizations such as the College will derive less income from their advertising due to greater taxes as a result of the UBIT. Although this may be true to an extent, publishers may try to reorganize their advertisements to comply with the suggestions offered by the Supreme Court.[94] If this is done, advertisements will be more carefully chosen and displayed in an attempt to coordinate them with the editorial articles of each issue. New developments in a field will be highlighted by commercial advertisements that assist in the continuing education of the reader. The benefits obtained by subscribing physicians will ultimately filter down to the medical consumers in the form of better medical care.

If publishers choose to continue repeating advertisements month after month, the income from these advertisements will undoubtedly be taxed under the Court's decision in *American College*.[95] This does not mean that a profit cannot be earned from these advertisements. Commercial enterprises that wish to continually advertise in these journals must realize that their advertisements will produce taxable income to the publisher. In order for exempt organizations to continue earning a reasonable profit, they may have to raise the advertising rates for those advertisements that produce unrelated business taxable income. If this occurs, then the UBIT has accomplished its purpose. It has placed the unrelated business activities of the exempt organization on the same tax status as those of the nonexempt organization. Yet, while the purpose of the UBIT may have been met, the probable increase in advertising rates for advertisements generating unrelated business taxable income may deter many of these advertisers from advertising. This result would defeat the medical journals' purpose of presenting as much continuing education as possible.

93. *See* Huffaker & Gut, *supra* note 84, at 4.
94. *See supra* notes 88–93 and accompanying text.
95. *See supra* notes 67–83 and accompanying text.

VI. Two Proposals for Legislative Change

The Supreme Court has attempted to illuminate the meaning of a very convoluted test: whether the conduct of an activity is substantially related to the exempt purpose of a tax-exempt organization.[96] The Court has done an admirable job, considering the vagueness of these statutes.[97] The uncertainty in this area, however, indicates that changes to the existing Code are warranted.

A. *Clarifying the "Substantially Related" Test*

The first task to which Congress should attend is alleviating some of the pitfalls associated with interpreting the UBIT statutes. The courts have been forced to decide case after case establishing very few legal conclusions on which exempt organizations and their lawyers may rely.[98] The judiciary often comments on lawyers' insatiable desire for concrete rules and interpretations, stating that such a scheme is usually impracticable due to the tremendous number of possible factual situations. Although concrete rules are often difficult to promulgate in this area, it does seem possible to combine new statutory language with the Supreme Court's *American College* decision in order to provide a more predictable test.

The Treasury Department previously added regulations designed to clarify what is or is not substantially related.[99] For the most part, these regulations have been unsatisfactory. To be related, the conduct of the activity must have a causal relationship to the exempt organization's purpose.[100] This relationship is achieved only when the conduct of the activity contributes importantly to the exempt purpose.[101] This language does not hint at what types of conduct satisfy this test. The Supreme Court has held that the conduct of the organization must show that its intention in carrying on the activity was to contribute importantly to the exempt function.[102] This test does not state whether the *primary* purpose of the activity must be to promote the exempt function or whether any substantial purpose of this type would suffice.

If the College chooses to segregate their advertisements, the question of what purpose is necessary would arise. The College may decide to publish all "established" drug advertisements at the beginning of an issue, while coordinating other advertisements that relate to the editorial content. The College would report all of the income associated with the "established" drug advertisements as unrelated business taxable income. Under this method, the College could continue to generate

96. *See* I.R.C. § 513(a) (West Supp. 1987).

97. Two of the major problems associated with vague statutes are: (1) the public's inability to plan its activities knowing how a statute functions, and (2) the difficulties the courts face in constantly having to interpret a statute to deal with each fact pattern that arises.

98. *See generally* Carolinas Farm & Power Equip. Dealers Ass'n v. United States, 699 F.2d 167 (4th Cir. 1983); Carle Found. v. United States, 611 F.2d 1192 (7th Cir. 1979), *cert. denied*, 449 U.S. 824 (1980); Oklahoma Cattlemen's Ass'n v. United States, 310 F. Supp. 320 (W.D. Okla. 1969); Mobile Arts & Sports Ass'n v. United States, 148 F. Supp. 311 (S.D. Ala. 1957); American Bar Ass'n v. United States, 53 A.F.T.R.2d 851 (N.D. Ill. 1984).

99. Treas. Reg. § 1.513-1(d) (1967).

100. *Id.* § 1.513-1(d)(2).

101. *Id.*

102. United States v. American College of Physicians, 475 U.S. 834, 849 (1986).

substantial amounts of income, albeit taxable income, while still deriving untaxed income from the proper presentation of other advertisements.

Prior to the Supreme Court's decision in *American College*, this method of segregating advertisements would probably have withstood an attack from the Service.[103] After the decision, however, a court could conceivably find that the College, by including "established" drug advertisements, is demonstrating an intention contrary to that required under the statute, and thus, *all* of its advertising income is taxable. This conclusion would be a permissible reading of the statutes, since they do provide that income from *any unrelated trade or business* is taxed.[104] This conclusion would also be a permissible interpretation of the Supreme Court's decision in *American College*.[105] The Court stated that the manner of conduct must evince an intention to contribute importantly.[106] It did not mention the possibility of more than one intention within a single activity.

At the present time, courts are forced to struggle with what intention is necessary to find an activity "substantially related." Congress should take the initiative and state that in order for an activity to be substantially related, the *primary* purpose in carrying on the trade or business must be to contribute importantly to the organization's exempt purpose.

This "primary purpose" standard would not be a new revelation in this area of taxation. The Treasury Department issued special regulations in 1967 that now apply only to taxable years beginning before December 13, 1967.[107] In these regulations, a trade or business is substantially related "if the *principal* purpose of such trade or business is to further . . . the purpose for which the organization is granted exemption."[108]

The United States Court of Claims in *Iowa State University of Science & Technology v. United States*[109] interpreted this "primary purpose" regulation in determining whether a university-owned television station was an unrelated trade or business. Iowa State owned a commercial television station that it used to promote many educational endeavors.[110] In deciding what the university's principal purpose was in operating the station, the court stated that profits are evidence that the business purpose was primary, although not conclusive.[111] "Of greater importance is the manner in which the enterprise is conducted. . . ."[112] After weighing the profit elements against the station's conduct relating to the educational aspects, the court held that the television station was not substantially related to the university's exempt

103. *See* Hi-Plains Hosp. v. United States, 670 F.2d 528 (5th Cir. 1982). The hospital was taxed on sales of pharmaceuticals to the general public because the activity was unrelated to its exempt purpose, while sales of pharmaceuticals to private patients of staff doctors were held to be related, and thus, untaxed. *See also* Huffaker & Gut, *supra* note 84, at 4.

104. I.R.C. § 512(a) (West Supp. 1987).

105. United States v. American College of Physicians, 475 U.S. 834 (1986).

106. *Id.* at 849.

107. *See* Treas. Reg. § 1.513-2 (1967).

108. *Id.* § 1.513-2(a)(4).

109. 500 F.2d 508 (Ct. Cl. 1974); *see supra* note 48.

110. Iowa State Univ. of Science & Technology v. United States, 500 F.2d 508, 520 (Ct. Cl. 1974).

111. *Id.* at 518.

112. *Id.*

functions.[113] Its primary purpose was found to be the generation of profit, not to further its exempt purpose of education.[114] This case is a prime example of a trial court's ability to factually determine the primary purpose for operating an activity.

Courts should determine this "primary purpose" from objective evidence of the manner in which an exempt organization conducts its activities. While this test requires a court to make a factual determination as to the primary purpose, it prohibits a small percentage of unrelated activities from causing all of an organization's income-producing activities to be taxed. If the College can convince a court that its primary purpose in advertising was to contribute importantly to its educational function, then only those advertisements that do not reflect this primary function should be taxed as unrelated business income. This further fragmentation of advertising activities is not in contradiction with decisions prior to *American College*,[115] and Congress should ensure that this interpretation is not changed by the Supreme Court's decision.

This proposed change in the existing Code would provide many benefits to the law surrounding the UBIT. By explicitly providing the necessary level of intention, Congress would add greater predictability and certainty to the law without making it inflexible. Exempt organizations would be able to structure their activities to exhibit that their primary purpose for engaging in a particular activity is to promote their exempt purpose. Aside from the greater predictability provided by such a change, courts would no longer be required to interpret the "substantially related" language of section 513.[116] All that will be necessary is a factual determination concerning the exempt organization's primary purpose.

B. *Special Exemption for Continuing Medical Education Journals*

Congress should heed the advice of Chief Justice Burger and realize the inherent distinctions between medical journals published by exempt entities and other periodicals. The primary goal of other periodicals is to make a profit. Whether one believes that advertisements published in exempt organization medical journals are provided to educate subscribers or generate income, it must be admitted that the *overall* goal of these journals is not to make a profit. These medical journals are published to assist in the continuing education of physicians.

Chief Justice Burger correctly pointed to the ever-burgeoning quantities of medical knowledge that physicians are expected to digest.[117] It is imperative to the continued progress of medical science that as much information as possible on new developments be available to physicians. In such a quickly changing field, new developments can mean the difference between life and death. There can be no argument that the medical profession's ability to provide the excellent health care demanded by the public is among the most important priorities in our society. The

113. *Id.* at 519.
114. *Id.*
115. *See supra* note 98.
116. I.R.C. § 513(a) (West Supp. 1987).
117. United States v. American College of Physicians, 475 U.S. 834, 850 (1986) (Burger, C.J., concurring).

health of our society is greatly affected by the medical profession's ability to continually educate itself on new developments. The tax laws should not be written to impede the vital process of continuing medical education.

If the advertising of exempt medical journals is taxed, the cost of advertising in these journals will most likely increase. If this result occurs, fewer companies may choose or even be able to advertise in these journals. Congress should be promoting medical advertising, not deterring it. As more medical advertisements appear in medical journals, more information will be passed on to subscribing physicians.

It is time for Congress to weigh the benefits of equalizing the tax status of exempt and nonexempt organizations with the detriment of decreasing the circulation of invaluable medical information. Congress should be doing all it can to assist physicians with the insurmountable task of keeping current in their chosen specialty. To assist in this vital task, the tax laws should be modified to promote the publication of medical journals[118] that attempt to provide continuing education for physicians. Income generated from advertisements related to the educational function of these journals should be exempt from the UBIT. Exempt organizations will be able to utilize untaxed advertising income to reduce or stabilize the cost of such publications, and by doing so, enhance the prospect of increased circulation.

VII. Conclusion

The tax on the unrelated activities of exempt organizations has traveled a course from rarely being imposed to the point at which any unrelated activity may be subject to the UBIT. By "fragmenting" the definition of a "trade or business," an activity may be taxed even though it may be but a small piece of the overall function of the exempt organization. This fragmentation approach has broadened the reach of the UBIT to activities, such as advertising, which had been treated as integral parts of the overall business.[119]

The Supreme Court's decision in *American College* should assist lower courts and tax-exempt organizations in their attempts to determine whether an activity is "substantially related" to the organization's exempt purpose. In order for an activity to be "substantially related," the conduct of such activity must evince an intention to use the goods or services for the purpose of contributing importantly to the organization's exempt purpose.[120] The emphasis is on the manner of conduct, not upon the benefits derived by the users.

The Court offered some suggestions that the College could adopt to avoid the imposition of the UBIT. Although these suggestions, if implemented, would regulate the content and manner of presentation of an exempt organization's advertisements, they may also enhance the educational value of such advertisements.

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118. This Case Comment should not be read as stating that only medical journals should be provided with special tax exemptions. Other professional journals may also be deserving, but discussion of each is beyond the scope of this Case Comment.

119. *See supra* notes 21–23 and accompanying text.

120. United States v. American College of Physicians, 475 U.S. 834, 849 (1986).

The Supreme Court has interpreted the law as it stands today, but now it is time for Congress to clarify and modify the existing statutes. First, Congress should explicitly state that in order for an activity to be "substantially related," the organization's *primary* purpose in carrying on the activity must be to contribute importantly to its exempt function.[121] This modification would eliminate a possible interpretation of the Supreme Court's decision which could ultimately tax a portion of an exempt organization's activity that is related to its exempt purpose. Second, Congress should enact an exception that exempts from the UBIT any income generated from related advertisements in continuing medical education journals of tax-exempt organizations. This change will help these exempt organizations in stabilizing the cost of medical journals, and thus, increase the circulation of vital information. An increase in circulation will assist the medical profession in its unenviable but necessary task of keeping current with the continually increasing quantities of medical information.

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121. *See supra* notes 98–116 and accompanying text.