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INTERNAL REVENUE SERVICE
TECHNICAL ADVICE MEMORANDUM

District Director

Taxpayer's Name: U.I.L. Nos.

513.00-00

Taxpayer's Address: 513 02-00

Taxpayer's EIN:

Tax Years Involved:

Date of Conference:

Legend:

X =

Issue:

Does the income derived from advertising in X's newspaper constitute income from an unrelated trade or business?

Facts:

X is an organization described in 501(c)(3) and 509(a)(2) of the Code. X's exempt purpose is to publish the daily student newspaper of a university, as an educational activity for the participating students.

X is organized separately from the university to allow for editorial independence. However, X has a close working relationship with the university. The university donates the use of office space, in a building which also houses the university's journalism department. The journalism department offers a course in which students must write some news articles for the newspaper. There is no comparable requirement for any advertising course (as it is difficult to solicit advertising on a one-time, free-lance basis).

X's all-volunteer board consists mostly of students, plus several faculty members. The editorial functions of the newspaper (including reporting and writing) are conducted entirely by students (about 60 writers, photographers, and

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editors). The non-editorial or "business" functions (including advertising, production, circulation, and building and administration) are conducted or supervised in whole or part by non-students, and subject to the general supervision of the general manager (a non-student). The editor-in-chief and the general manager both report directly to the board.

The business functions of the newspaper were conducted by 17 student employees and 10 non-student employees during the years at issue. The non-student employees primarily served mentor or supervisory roles, or in some cases, positions for which students were ill-suited to serve.

The two types of advertising in the newspaper are (1) "display" or "retail" ads, and (2) "classified" ads. Retail ads consist of two types: (1) local ads, which are solicited and designed by X's advertising salesmen and graphics designer, and (2) national, "camera-ready" ads, which entail no solicitation or design, and are handled by X's advertising manager. Most of the classified ads are not obtained by the active solicitation of X's advertising salesmen, but some businesses solicited choose to advertise in the classified section (classified ads are less expensive than display ads). Once designed, ads are sent to the business customer for approval and to the production department for layout, with the coordination of the editorial staff.

The retail advertising function had two full-time non-student employees and 8 student advertising salesmen who each worked about 30 hours per week. The advertising manager and advertising office coordinator both served largely supervisory roles, and the latter was also primarily responsible for the proper scheduling of ads. Three other students each worked about 15-20 hours per week. Two served as proofreaders and "runners" (running proposed ads to business customers for final approval) of the display ads. The third served as the graphic artist for the display ads.

Two non-students, a classified advertising manager and a part-time clerk, received most of the classified ads. Both spent most of their time handling classified ad phone calls, during prime school hours (10 a.m. to 3 p.m.). X has determined that it is impractical to coordinate the conduct of such work by students during such hours, particularly given the limited educational benefits of such work.

However, as with national display ads, students were involved with classified ads in the production layout process (and sometimes in solicitation and graphics design, in the case

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of classified ads placed by businesses). The production staff consisted of 4-5 students (15-20 hours per week, a full-time non-student supervisor (responsible for X's expensive equipment and keeping abreast of industry trends), and a non-student night-time assistant (serving the hours 5 to 11 p.m.) After initial layout, non-students generally proofread the ads before the final layout.

Other non-students employed by X included a bookkeeper (to promote uniformity, continuity, and accuracy in its financial records--a student bookkeeper once nearly led X to insolvency), a secretary/receptionist, and one of its four employees in the circulation department.

X's sources of income in the two years at issue were as follows:

year 1	year 2	source
75%	75%	retail advertising
13%	14%	classified advertising
10%	9%	subscriptions of student body government
1%	1%	individual subscriptions
1%	1%	miscellaneous
100%	100%	

The following charts show payroll distributions:

1994	students	non-students	% of budget
editorial	100%	0%	26%
retail advertising	44%	56%	25%
production	52%	48%	19%
building/admin	1%	99%	13%
classified ads	1%	99%	7%
business office	5%	95%	7%
circulation	72%	28%	3%
			100%

1995	students	non-students	% of budget
editorial	100%	0%	27%
retail advertising	45%	55%	25%
production	36%	64%	18%
building/admin	1%	99%	14%
classified ads	5%	95%	7%
business office	0%	100%	6%
circulation	75%	25%	3%
			100%

Applicable Law:

Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax organizations organized and operated exclusively for charitable, educational, and certain other purposes.

Section 512(a)(1) of the Code defines "unrelated business taxable income" generally as gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions, with certain modifications.

Section 513(a) of the Code generally defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable or other purpose or function constituting the basis for its exemption under section 501.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.

Section 1.501(c)(3)-1(3)(a) of the Income Tax Regulations provides that education includes the instruction or training of the individual for the purpose of improving or developing his capabilities.

Section 1.513-1(b) of the regulations provides that the primary objective of adoption of the unrelated business income tax was 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. In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162--and which, in addition, is not substantially related to the performance of exempt functions--presents sufficient likelihood of unfair competition to be within the policy of the tax. Activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization

periodical which contains editorial matter related to the exempt purposes of the organization.

Section 1.513-1(d)(2) of the regulations provides that for the conduct of a trade or business to be substantially related to purposes for which an exemption is granted, the production or distribution of the goods or the performance of the services must contribute importantly to the accomplishment of those purposes. This determination depends in each case upon the facts and circumstances involved.

Section 1.513-1(d)(3) of the regulations provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

Section 1.513-1(d)(4)(iv) of the regulations provides that in certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. For example, sections 1.512(a)-1(d)(1) and (f)(1) indicate that an exempt organization's sale of advertising in its periodical is generally an unrelated trade or business activity involving the exploitation of an exempt activity; namely, the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical.

In Example (5) of section 1.513-1(d)(4)(iv) of the regulations, Y, an exempt university, provides facilities,

instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by means of student instruction of other students in the editorial and advertising activities and student participation in those activities.

Rev. Rul. 55-676, 1955-2 C.B. 266, held that a radio station conducted in a manner similar to commercial undertakings by a 501(c)(3) university constituted an unrelated business under section 513 of the Code. The radio station was acquired by the university as a source of income to the school, to serve as a laboratory for training students in radio, as a medium for advertising the university, and as a medium for adult education. It was affiliated with a network, was assigned a regular frequency, and operated on a day and night basis. Although the station was used in part in carrying out the educational program of the university, the greatest portion of its time was devoted to activities conducted by regularly constituted commercial radio stations. The Service reasoned that a trade or business not otherwise related does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose; a trade or business is considered related if operated primarily as an integral part of the educational program of the university, but is considered unrelated if operated in substantially the same manner as a commercial operation. (This reasoning was adopted in section 1.513-2 of the regulations, in effect for tax years beginning before Dec. 13, 1967.)

Rev. Rul. 68-581, 1968-2 C.B. 250, held that an exempt vocational school's sale of articles made by its students was a related trade or business under section 513 of the Code, but sale of articles made by non-students was unrelated trade or business. The school was largely devoted to teaching skills in weaving. It

also operated a handicraft shop, where articles made by the students as part of their regular courses of instruction were sold. The students were paid a percentage of the sales price. In addition, the shop sold woven products made by local residents, many of whom were former students of the school. The local residents made articles at home according to the shop's specifications. The shop manager periodically inspected the articles during their manufacture to ensure that desired standards of style and quality were met. Any qualified weaver could participate in this program. The completed articles were purchased by the organization and sold in its shop. The Service reasoned that while the sale of articles made by students clearly fell within the scope of section 1.513-1(d)(4)(ii) of the regulations, the sale of articles made by local residents did not, their production did not serve an educational purpose, and the local residents were not otherwise unable to support themselves.

In Rev. Rul. 73-128, 1973-1 C.B. 222, an organization was formed to provide educational and vocational training to nonskilled persons unable to find gainful employment due to inadequate education. The job training centered around the manufacture and sale of toys. Income from the toy business was used to finance the organization's other community service activities. Trainees were placed in permanent jobs in the community as soon as they were adequately trained. The Service held that the organization operated exclusively for charitable and educational purposes under section 501(c)(3) of the Code despite the conduct of a toy business where there was a clear causal relationship between the manufacturing activity and the training of the individuals to improve their capabilities, and there was no evidence that the business was conducted on a larger scale than necessary to accomplish the charitable purpose.

In Rev. Rul. 75-472, 1975-2 C.B. 208, a halfway house organized to provide room, board, therapy, and counseling for persons discharged from alcoholic treatment centers, which also operated a furniture shop to provide full-time employment for its residents with any profits applied to operating costs of the halfway house, was exempt under section 501(c)(3) of the Code and did not conduct an unrelated business. All work was performed by the house residents, except for the trainers and supervisors. The residents received compensation for the work, and paid a fee for the room and board. The training was not intended to achieve a significant increase in saleable skills since most of the residents already had other saleable skills. The shop was substantially related to the organization's charitable purpose by affording the residents temporary employment and enabling them to

cope with emotional problems by developing a sense of work habits and independence.

In Rev. Rul. 76-37, 1976-1 C.B. 148, an organization that purchased building lots, furnished the lots and funds to a public vocational training center for use in its on-the-job home construction training program, sold the completed homes (70% of which was built by the trainees) to the general public at fair market value, and used the income from home sales to finance new projects and obtain vocational training equipment for the public school system, qualified for exemption under section 501(c)(3) of the Code, and the sale of the homes was not an unrelated business. The Service reasoned that the completed houses were products of an exempt function and sold in substantially the same state they were in upon completion of the exempt function. Also, only as many houses were built as were needed for the training program.

United States v. American College of Physicians, 475 U.S. 834 (1986), held that the performance of advertising services may under some circumstances constitute a related trade or business, although the exempt medical organization's advertising in its journal was held an unrelated business under the circumstances. In making its determination, the court focused on the manner in which the organization operated its advertising business.

Iowa State University of Science and Technology v. United States, 500 F.2d 508 (Ct.Cl. 1974), held a television station owned and operated by a university to be unrelated trade or business. The station's affiliation with a major television network (ABC), its advertising operations, and its emphasis on entertainment programming (75% of total programming) were virtually indistinguishable from those of other commercial stations. The station produced and telecasted educational programming, including subjects in agriculture and home economics and classroom instruction by closed circuit. The station also helped the university prepare students for careers in television broadcasting and advertising, by occasional staff participation in course presentations, by occasional student use of facilities, and by part-time employment of students. The station was not meant to be a vocational training center for students. The court, applying section 1.513-2 of the regulations (in effect for tax years prior to Dec. 13, 1967), held that the station's principal purpose was not to further educational purposes but to maximize revenue.

S. Rep. No. 2375, 81st Cong., 2d Sess. 107 (1950), in defining unrelated trade or business, states that a wheat farm

operated by an exempt agricultural college as part of its educational program would be considered a related business. However, the manufacture and sale of automobile tires by a college would ordinarily be considered an unrelated business. A trade or business which is otherwise unrelated would not become related merely because some incidental use is made of the business facilities to further the exempt purpose. For example, the tire business noted above would not become substantially related even though some students as part of their educational program perform some minor clerical or bookkeeping functions.

Rationale:

X's advertising activity is a business regularly carried on by it. The question is whether the activity is substantially related to its educational purpose--i.e., whether performance of the advertising service contributes importantly to the accomplishment of its educational purpose.

Generally, an exempt organization's advertising in its periodical is regarded as an unrelated business, even if the publication of the editorial content of the periodical furthers exempt purposes. The Supreme Court in American College of Physicians held open the possibility that advertising may, under some circumstances, educate the readers, and thus be a related business. In the case of a student-run newspaper, however, the advertising function, like the other newspaper functions, may provide vocational training (recognized as an educational purpose) to the participating students.

Example (5) of section 1.513-1(d)(4)(iv) of the regulations indicates that such advertising is a related business where the advertising is conducted entirely by students, or by students under faculty supervision. We believe that the example in the regulations is more of a safe harbor than a bright-line rule intended to sharply distinguish related from unrelated business. Thus, there is room for non-student employees in the advertising department, especially where they serve in a managerial or training capacity, or in positions in which it is impractical to employ students. Several Revenue Rulings (e.g., 73-128 and 76-37) indicate that vocational training programs may be educational even where conducted in part by non-student labor. However, mere incidental student involvement will not transform an otherwise unrelated business into a related one. The enterprise should be primarily a student enterprise.

Under the facts presented, although the retail advertising activity is managed by non-student employees, most of such activity is performed by students. We regard the advertising activity as sufficiently similar to Example (5), and therefore as related business.

Although the allocation regulations under section 512 of the Code appear to regard advertising for a given periodical as a singular activity, other parts of the regulations provide for "fragmenting" business activity into related and unrelated components. See sections 513(c) of the Code and 1.513-1(b) and 1.513-1(d)(3) of the regulations. There may be cases where we would find one advertising activity (e.g., display advertising) for a periodical to be related business and another advertising activity (e.g., classified advertising) for the same periodical to be unrelated business.

Although the classified advertising in this case presents a much closer question than the display advertising, we find the advertising business also to be substantially related to the performance of X's educational purpose. Although students may not man the phones for such ads or proofread the ads, they are mainly responsible for dealing with the ads in the layout process, and sometimes in the solicitation and graphic design process. Under the facts presented, student involvement with the classified advertisements is more than incidental.

Conclusion:

The income derived from advertising in X's newspaper constitutes income from a trade or business the conduct of which is substantially related to the performance of X's educational purpose.

A copy of this technical advice memorandum is to be given to X. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

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