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Comments on IRS Announcement 2000-84 Regarding the Need for Guidance Clarifying the Application of the Internal Revenue Code To Use of the Internet by Exempt Organizations

American Institute of Certified Public Accountants. Taxation of Internet Services Task Force

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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GENERAL COMMENTS

IRS Announcement 2000-84 notes that exempt organizations are increasingly using the Internet to perform activities that could be carried on through the traditional media of radio, television, print or direct mailings. The AICPA believes that the Internet is merely a new communication medium and a new vehicle to conduct such activities. Thus, existing rules and regulations pertaining to activities of an exempt organization should apply equally to those activities utilizing this new medium. As described in our specific comments, different aspects of an organization's Internet activities and Web site can be scrutinized by employing existing principles for activities carried on by the historical means of radio, television, and the like.

In many cases, Internet usage only represents the evolution of the delivery mechanisms for conveying information. The AICPA believes that substantially similar offline and online activities can be viewed as a single activity. In sum, existing tax rules pertaining to various activities of exempt organizations are generally adequate to determine the consequences of such activities conducted via the Internet.

To obtain recognition and maintain tax-exempt status, a nonprofit organization must be dedicated to, and devote its primary energies to, conducting activities that accomplish a qualifying exempt purpose. The standards for qualification under the different categories of section 501(c) are well defined and documented in Treasury regulations, Internal Revenue manuals for exempt organizations and private foundations, court decisions, and countless published and private IRS rulings.

The use of a particular medium for accomplishing a charitable or other nonprofit mission should not, in and of itself, challenge the appropriateness of an organization's tax-exempt status. Rather, existing disqualification rules and regulations should determine the status of an exempt organization that happens to conduct its activities on the Internet.

SPECIFIC COMMENTS

Contemporaneous Documentation

The AICPA suggests that tax-exempt organizations be encouraged, but not required, to maintain contemporaneous documentation regarding their Web sites. In particular, any compliance requirements should be eased for smaller exempt organizations to reflect

their more limited resources. An organization that does establish policies and record facts and circumstances regarding its Web site shall be presumed to have exercised good faith in documenting the exempt purposes for maintaining its Web site. We suggest the following procedures:

- Each tax-exempt organization that maintains a Web site should document its motivation and purposes for maintaining the site. It should develop policies regarding content of the site, including an approval system for adding new information to the site and for entering into written agreements with persons responsible for chat rooms and the like. Most particularly, a tax-exempt organization should document the motivation for connecting its site to other sites utilizing active hyperlinks. Organizations exempt under section 501(c)(3) that conduct voter education programs that discuss election issues, and particularly those that link to sites of political parties or candidates, should adopt procedures to assure the information is conveyed in an unbiased and impartial fashion.

- Tax-exempt organizations should establish accounting procedures to capture data needed to allocate the cost of the Internet activity between its related and unrelated aspects. Personnel should maintain time records to capture effort expended in regard to Internet activity. Direct costs attributable to a site should be, when possible, captured according to its programmatic or related and its unrelated aspects.

Agency Responsibility

To what extent are statements made by subscribers to a forum, such as a listserv or newsgroup, attributable to an exempt organization that maintains the forum? Does attribution vary depending on the level of participation of the exempt organization in maintaining the forum (e.g., if the organization moderates discussion, acts as editor, etc.)?

In order for an exempt organization to further its exempt purposes, in part, through Internet activity, the boundaries of its agency relationship with its Web site must be set at a level that is both consistent with existing law and administratively feasible. There must be limits on the degree to which an exempt organization is held responsible, through links from its home page, for activities appearing on Web pages of other organizations. We do not believe that it is appropriate to charge an exempt organization with the ongoing oversight of continuously changing Web pages over which the organization has no control.

There are two primary fact patterns to consider in connection with this issue. In *Situation 1*, which applies to all exempt organizations, the home page or site index of an exempt organization contains links to the Web pages of other organizations, which may or may not be related to the exempt organization. In all instances, a visitor to the organization's Web site must engage in an affirmative act of clicking on the link, in order to go from the home page or site index to another Web site. *Situation 2* is generally applicable only to

large exempt organizations, such as universities, which provide the technical infrastructure for Internet activity of faculty and students and various subgroups comprised of those individuals who set up their own Web sites and e-mail accounts (i.e., Internet Service Providers).

The goal in *Situation 1* is to define boundaries in a manner that holds an exempt organization to an appropriate standard in monitoring Web pages accessible through links from its home page without creating undue administrative burdens on the organization. We suggest that a standard limiting an organization's responsibility to monitoring its own "Home Web Site" would create an administratively workable and fair boundary. For purposes of this discussion, a "Home Web Site" is defined to include: (i) an organization's home page, (ii) its home page site index, and (iii) all Web pages that can be accessed directly by clicking on any title listed in the home page site index or on the organization's home page itself ("Directly Linked Web Pages"). A Home Web Site does not include any Web pages subsequently accessible through links appearing on any Directly Linked Web Pages. The organization, whose name appears as the host of the Home Web Site, will hereafter be referred to as the Host Organization.

However, please note that many organizations have "nested" or "tiered" pages that are not directly accessible from their home pages but for which the organization has responsibility. Page organization is entirely a function of design, and differs from entity to entity. An alternative definition for a Home Web Site would encompass those pages that the organization stores on its own server or pays another Web host to store; the organization would be responsible for monitoring both types of pages.

The ability to recognize the boundaries of a Home Web Site for a Host organization will differ, in part, according to the size of the organization. For most Host Organizations, the domain name or the name of the organization on the home page will be self-evident and can define the boundaries. For larger institutions with many subparts, however, the task is more complex. For example, consider a university with several graduate and professional schools. From the university-wide home page visitors can easily link to the Web pages of each underlying school and department within the university. Visitors can also go directly to those Web pages through various search engines available on the Internet. As a single tax-exempt entity, however, we believe that the university's Home Web Site, constitutes the Home Web Site for purposes of monitoring responsibility. We do not believe that any subpart of an entity can be treated as a Host Organization or have a Home Web Site, or be responsible for monitoring the Host Organization's Web pages.

In our view, it is only possible to reach a conclusion regarding whether information on Directly Linked Pages should be imputed to the Host Organization by reviewing all facts and circumstances surrounding the relevant hyperlink. It would, however, be helpful to create a set of guidelines to enable a Host Organization to recognize when it would likely be held responsible for the content of Directly Linked Web Pages. It would also be helpful to define an administratively feasible pattern for periodic review of Directly Linked Web sites, which could serve as a safe harbor for the Host Organization.

As discussed below, an organization can choose to include an effective disclaimer in connection with a hyperlink. Absent such a disclaimer, however, the following discussion sets forth the proposed guidelines and safe harbor applicable to *Situation 1*:

1) The Host Organization must review the relevant Directly Linked Web Page on the date the Host Organization permits a link to be established either from its own home page or from its site index ("Starting Date") or the date it has actual knowledge ("Knowledge Date") about material on a site. To the extent that the Directly Linked Web Page contains material that would affect the Host Organization's tax status (e.g., lobbying or political activity) if such material were to appear directly on the Host Organization's home page, then the non-exempt activity would be imputed to the Host Organization from the Starting Date until such activity is no longer accessible from the Directly Linked Web Page. In characterizing the material with respect to the Host Organization, however, all facts and circumstances must be reviewed to determine whether such activity would, for example, be lobbying or political activity or educational in nature if engaged in directly by the Host Organization.

2) If, however, on the Starting Date the Directly Linked Web Page contains only material, that would not be construed as lobbying or political activity by the Host Organization, then no such activity would be imputed to the Host Organization until the Knowledge Date that such material is appearing on a Directly Linked Web Page. The Host Organization then would have a reasonable time after the Knowledge Date to decide either to permit the link to continue or to terminate it. If the Host Organization permits the link to remain, then the material appearing on the Directly Linked Web Page would be imputed to the Host Organization from the Knowledge Date until the activity disappears from the Directly Linked Web Page. If the Host Organization decides to terminate the link and does so within a reasonable time after the Knowledge Date, the activity should not be imputed to the Host Organization.

3) As a safe harbor, the Host Organization may review all Directly Linked Web Pages with respect to its Home Web Site once a year and should keep a record of its findings sufficient to show the content of each Directly Linked Web Page on each such date. The Host Organization would be held to have actual knowledge of the contents of each Directly Linked Web Page on each such annual review date. A Host Organization, which has properly complied with these safe harbor annual review provisions, is entitled to presume that the material on each reviewed Directly Linked Web Page would remain the same until the next annual review date unless the Host Organization receives actual knowledge of a change.

The preceding framework makes sense administratively and does not place an undue burden on an exempt organization. This framework is also consistent with existing principles of agency law. Under agency law, the actions of a person or entity, which is acting as an agent of the Host Organization, will be imputed to the exempt organization during the period that such agent is acting on behalf of and for the benefit of the exempt organization. Even "an independent contractor can be an agent if, and to the extent that, the contractor **acts for the benefit of another and under its control** in a particular

transaction." *State Police Ass'n v. Commissioner*, 125 F.3d 1, 18 (1st Cir. 1997) [emphasis added]; see also Restatement (Second) of Agency sections 2, 14N (1957). "[T]he label which contracting parties place on their relationship is not decisive of their status vis-a-vis third parties. See *Board of Trade v. Hammond Elevator Co.*, 198 U.S. 424, 437, 49 L. Ed. 1111, 25 S. Ct. 740 (1905)." *State Police*, 125 F.3d at 19. The emphasis is on whether the person or entity in question is acting for the benefit of and under the control of the Host Organization rather than on any particular label, which may attach to the relationship.

In the context of a Home Web Site, this requires an examination of the relationship between the Host Organization and organizations whose Web pages can be accessed from the Host Organization's home page or Home Web Site index. Fundamental principles of agency law should not change merely because the activity is occurring over the Internet, rather than in another forum.

In creating a Home Web Site and deciding which Web sites can and cannot be listed in the index, the Host Organization is deciding how it will present itself. The Host Organization can certainly control what is listed in the site index and, it could be argued, is responsible for what appears on any Directly Linked Web Page at the time the link to that page is established. Where a Host Organization is a large institution, however, the reality is that the Directly Linked Web Pages are managed by a number of subgroups within the institution over which the Host Organization does not have ongoing control of the sort necessary to establish an ongoing agency relationship. For organizations of any size, a decision may be made to create a link from its home page to a Web page of an organization over which it has no real control. In either instance, the Host Organization is providing easier access to the Directly Linked Web Pages than if visitors to the Host Organization's Home Web Site had to access them in another way. **Merely providing access, however, does not create an agency relationship.**

The Host Organization can create a set of guidelines that serve as conditions for inclusion in the Home Web Site index and remove a Directly Linked Web Page if those guidelines are violated. However, the Host Organization cannot constantly monitor the content of each continuously changing Directly Linked Web Page and can remove a link if it learns that the page is in violation of the guidelines.

Because the Host Organization lacks ongoing control of Directly Linked Web Pages, the Host Organization cannot have an agency relationship with the organizations managing the Directly Linked Web Pages. Thus, no activity on any Directly Linked Web Page should be imputed to the Host Organization. A more conservative position, however, would hold the Host Organization responsible for the contents of a Directly Linked Web Page under the limited circumstances suggested in the rules set forth above.

Given the tenuous character of the conclusion that there is an agency relationship between the Host Organization and organizations hosting Directly Linked Web Pages, there is no basis for arguing that links from the Directly Linked Web Pages to subsequent Web pages create an agency relationship between the Host Organization and those

second-tier Web pages. Therefore, no activity from subsequently linked Web pages should be imputed back to the Host Organization, absent facts and circumstances external to the Internet links that establish an agency relationship.

The Host Organization always has the option of including an effective disclaimer sufficiently close to a hyperlink to be meaningful. Such a disclaimer would make it clear that the Host Organization is not endorsing or supporting any material appearing on the Directly Linked Web Page and would make it clear that no agency relationship exists. With respect to a Directly Linked Web Page containing political activity, a disclaimer modeled on the type of disclaimer applicable to a candidate forum could support the conclusion that the Host Organization is involved in an educational activity rather than a political activity. In other fact patterns, a disclaimer would eliminate the possibility that any material on the Directly Linked Web Page would be imputed back to the Host Organization.

The rules set forth in this section take into consideration the preceding theoretical agency arguments and the administrative practicalities involved. We propose that the analysis set forth above would provide a valid standard for addressing the fact pattern described in *Situation 1*.

In *Situation 2* the analysis is rather different. There, an exempt organization such as a university is providing the technical infrastructure for the Internet activities of individuals, essentially serving as an Internet Service Provider, for example, by allowing students and faculty members to have e-mail accounts and to set up their own Web sites on the university's computer system. The issue is whether the activities of the individuals on the Internet should, in any way, be imputed to the exempt organization. Our position is that they should not.

For *Situation 2*, we can analogize our facts to those considered in the Digital Millennium Copyright Act, 17 U.S.C. Section 512 (DMCA). In enacting such legislation, Congress created a safe harbor for Internet Service Providers with respect to the copyright infringement laws. Under that safe harbor, an exempt organization will not violate the copyright laws merely because it is providing the technical infrastructure for the Internet activities of individuals or entities.

We suggest that a similar safe harbor would be appropriate for considering the impact that Internet Service Provider activity should have on the tax-exempt status or taxable income of such organizations. Language that tracks the DMCA safe harbor may be appropriate.

The Nature of Links

A link from the Host Organization's Home Web Site to a Directly Linked Web Page can be characterized only by looking at the specific facts and circumstances. The following summarize some of the possible characterizations:

1) A link can be analogous to a directory listing of the Web address of the organization hosting the Directly Linked Web Page (Linked Organization). The Host Organization passively allows access to the Linked Organization's Web address and the link is only activated by an affirmative act of a visitor to the Host Organization's Home Web Site. If no cash flows back to the Host Organization as a result of that link, then there are no Unrelated Business Income Taxation (UBIT) consequences.

2) A link can be provided for informational purposes only. For example, footnotes in an article in an on-line periodical can contain links from the footnotes to underlying source material. No cash comes back to the Host Organization in connection with these links. Informational hyperlinks are fundamentally different from those described in *Situation 1* of the Agency Responsibility section above, because it is clear to the user that they are simply research tools. In addition to having no UBIT consequences, no material from the Directly Linked Web Page should be imputed back to the Host Organization through an informational link of this sort.

3) If cash flows back, directly or indirectly, to the Host Organization as a result of the link, then the Organization needs to decide how to characterize that cash flow. Its characterization depends on how the link is viewed.

   a) If the link in the Home Web Site is presented in a context that would cause the link and its surrounding presentation to be characterized as advertising, then the cash flow to the Host Organization is taxable advertising income;

   b) If it is not advertising income, then the underlying business deal between the Host Organization and the Linked Organization must be reviewed in order to characterize the cash flow to the Host Organization. For example:

      i) If the Host Organization receives a single payment from the Linked Organization for providing the link and the link is not advertising, then it should be construed either as corporate sponsorship or as a lump sum royalty payment, if the following royalty analysis applies to the fact pattern.

      ii) If cash flow to the Host Organization is related either to: (i) a percentage of sales or profit made by the Linked Organization on sales to purchasers who access the Directly Linked Web Page via a link from the Home Web Site or (ii) the number of "hits" to the Directly Linked Web Page from the Home Web Site, then it is possible to characterize such cash flow properly as royalty income.

The cash flow in paragraph 3) b) ii) should be characterized as royalty income because the Linked Organization is essentially using the name, logo, and reputation of the Host Organization in order to attract additional visitors to the Directly Linked Web Page or to increase sales. Therefore, payments to the Host Organization are directly correlated with that benefit.

This analysis takes the royalty analysis set forth in Sierra Club, Inc. v. Commissioner, 86 F.3d 1526 (9th Cir. 1996) and its progeny and applies it in the new venue of the Internet.

> "[R]oyalty" commonly refers to a payment made to the owner of property for permitting another to use the property. The payment is typically a percentage of profits or a specified sum per item sold; the property is typically either an intangible property right - such as a patent, trademark, or copyright -- or a right relating to the development of natural resources ... [B]y definition, royalties do not include payments for personal services. Id. at 1544; citing Rev. Rul. 81-178, 1981-2 C.B. 135.

The Ninth Circuit held that "under section 512(b)(2) 'royalties' are payments for the right to use intangible property. . . .[and] that a royalty is by definition 'passive' and thus cannot include compensation for services rendered by the owner of the property." Id. at 1544-45.

The appellate court also stated that "mere retention of quality control rights by a licensor in a licensing agreement situation does not cause payments to the licensor under the agreements to lose their characterization as royalties." Id. at 1549, n. 15, citing Rev. Rul. 81-178. For example, the Sierra Club provided a rate sheet listing the fees it charged for use of each copyrighted and it retained the right to approve how the design was used and marketed.

Oregon State Univ. Alumni Ass'n v. Commissioner, 193 F.3d 1098, 1010 (9th Cir. Cases, 1999) involved an affinity credit card program. The circuit court found that "[t]he bank designed the program, promoted it, and maintained it, with de minimis effort from the schools. What little the schools did pursuant to the agreements was the minimal administrative work necessary to give their mailing lists to the bank, and to prevent the bank from promoting the cards in such a way as to sour the associations' relations with their alumni." In both cases, the Ninth Circuit viewed the fact pattern in its entirety and deemed a royalty analysis appropriate. We believe that the royalty analysis is also appropriate for Internet links.

Under a royalty analysis, we must conclude that the Host Organization is not providing substantial services in connection with the link. Setting up a link and maintaining it are basic, minimal administrative functions analogous to the minimal functions in Sierra Club and in Oregon State. In those cases, minimal administrative functions were not construed to be significant services that would undermine royalty treatment.

Visitors to a Host Organization's Home Web Site are drawn to that site for many reasons. In part, an aspect of the Host Organization's name and reputation made it seem appropriate for a visitor to seek the Home Web Site. Having reached the Home Web Site, those visitors can then use the links they find there to access Directly Linked Web Pages. The linked Organizations are, therefore, benefiting from the name and reputation of the Host Organization by attracting larger audiences to the Web sites and possibly increasing sales.

Royalties are traditionally paid for the name and reputation of intangible property. Therefore, absent significant services by the Host Organization, cash flow to the Host Organization with respect to a link, should be properly characterized as royalty income, whether the cash flow is directly or indirectly correlated with (i) a percentage of sales or profit made by the Linked Organization on sales to purchasers who access the Directly Linked Web Page via a link from the Home Web Site or (ii) the number of "hits" to the Directly Linked Web Page from the Home Web Site. As royalty income, the cash flow would be excluded from UBI under section 512(b)(2).

Nature of a Web Site

Does a Web site constitute a single publication or communication? If not, how should it be separated into distinct publications or communications?

This question first requires an examination of the nature of a Web site. Generally, a Web site is accessible to all. However, on certain sites anyone can enter data, therefore, the content of the site is constantly changing. Such sites, or portions of sites, are analogous to a classroom or conference in which ideas and information are exchanged. The sponsoring organization cannot be held responsible for information that is freely conveyed on such sites. Thus, a Web site should be defined as those electronic pages over which the tax-exempt organization has control as discussed above.

To adopt this standard, the boundaries for control of electronic pages must be defined. An organization's Home Web Site would create a workable and fair boundary for most exempt organizations. The Home Web Site should include: (1) an organization's home page, (2) its home page site index, and (3) all Web pages that can be accessed directly by clicking on any title listed in the home page site index or the home page itself (Directly Linked Web Pages). A Home Web Site should not include any Web pages subsequently accessible through links appearing on a Directly Linked Web Pages (unless such links are merely reiterations of links also listed in the home page site index or on the home page itself).

Furthermore, we see a Web site as a unique electronic communications tool that may, in any given example, contain aspects of any of the following:

- Publication
- Periodical
- Television
- Radio
- Telephone
- Bulletin Board
- Meeting Room
- Retail Store

Therefore, in most instances, a Web site is not a single publication or communication. It may have parts that serve entirely different functions that do not fit traditional classification as either a publication or communication.

The division of a Web site into discrete activities depends upon the facts and circumstances of that particular site. For example, some online retailing activities might be considered extensions of the organization's "brick and mortar" retailing operations and properly be combined with those activities. Other online retailing activity could be considered as a discrete activity unto itself.

There is another question that is key to discussions of both corporate sponsorship and unrelated business income from advertising on the Web site: *Is a Web site, or portion thereof, ever considered to be a periodical?* Proposed reg. section 1.513-4(b) provides that the corporate sponsorship exclusion does not apply to income derived from the sale of advertising or acknowledgements in *exempt organization periodicals*. Reg. section 1.512(a)(f) has specific rules for calculation of unrelated business income from advertising in the *periodicals* of exempt organizations. Thus, we feel that future guidance has to address this issue.

Neither the proposed sponsorship regulations nor the advertising regulations provide an exact definition of a periodical. IRS Publication 598 defines a periodical as "any regularly scheduled and printed material (for example, a monthly journal) published by or on behalf of the organization." Since information from a Web site is easily *printable*, we acknowledge that Web publications can be considered as "printed."

We propose that "periodical" may include electronically transmitted material -- including Web sites or portions thereof -- if it meets all of the following criteria:

- The material is updated on a regular quarterly or more frequent basis, with announcements, news articles and other editorial content of the sort commonly found in printed periodicals distributed to members and other constituents;

- There is an editor or editorial board with the traditional responsibilities (such as selection, solicitation and editing of content) of editors in print periodicals; and

- For a portion of a Web site, it is clearly separated from other, non-periodical sections of that Web site.

All other electronic transmission of material would not be considered to be a periodical.

We further propose that when an online periodical is, in all significant ways, merely an online version of an organization's print periodical, both activities be combined as one activity. The income and costs associated with both the Web and print periodical would be combined for calculation of unrelated business income.

Exploited Exempt Activity

When allocating expenses for a Web site, what methodology is appropriate? For example, should allocation be based on Web pages (which, unlike print publications, may not be of equal size)?

Unlike other publications of an exempt organization, a Web site may be modified on a daily basis. To what extent and by what means should an exempt organization maintain the information from prior versions of the organization's Web site?

Reg. section 1.513-1(d)(4)(iv) states: "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." Of the seven examples of exploited exempt activity in this announcement, five relate to advertising presented in various formats – one to radio advertising, and one to printed publications. Under these rules, Web site advertising is an exploited exempt activity.

When Web site advertising is classified as an exploited exempt activity, it is the Web site itself that is exploited. Example 4 of reg. section 1.513-1(d)(4)(iv) describes the listening audience that resulted from the organization's exempt activities as the function, or activity, being exploited: "Notwithstanding the fact that the production of the advertising income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business." Id. Therefore, gross income from the activity would include only advertising revenue and not include the organization's donations or membership fees.

There may be situations under which only a portion of an exempt organization's Web site might be considered to be exploited, for example, where an organization has set up a separate site, under a separate domain name devoted to a specific activity (possibly advertising). Under these circumstances, it may be appropriate to consider only the specific portion of the organization's Web activity as being exploited.

Organizations reporting exploited exempt activity income and expense on Form 990-T must also report gross income from the activity that is being exploited, as well as expenses attributable to that activity. If the activity being exploited is the Web site itself, then the organization would be required to report income generated by and through the Web site, or a portion of the site. In this instance, we suggest that the organization report only the activity generated through its Web site, whether it be donations, sales of materials or services, etc. Correspondingly, the expenses attributable to the exploited activity would be the cost of operating and maintaining the Web site (or portion thereof) itself.

In keeping with our position that most online advertising activity should be classified as non-periodical exploited exempt activity, we think Web advertising activity should be reported on Schedule I of Form 990-T. Advertising on Web pages meeting the definition

of an online periodical, as discussed above, should be reported on Schedule J of Form 990-T.

Example: Charity XYZ maintains a simple Web site through which it solicits donations and sells educational booklets. Donors and customers may make donations and order merchandise directly through the Web site itself, which features a secure order form and "shopping cart" software enabling direct purchases via credit card or electronic funds transfer. Charity XYZ also sells advertising space on its Web pages. Charity XYZ does not publish a periodical. For its most recent year, Charity XYZ had Web page advertising income of $10,000 and direct Web page advertising expense of $8,000. Net Web page advertising income, after direct expenses, is $2,000. Charity XYZ also had overall donations of $500,000, and overall expenses of $490,000. Through its financial records, Charity XYZ determined that $15,000 of its overall donations had been made through its Web site. Furthermore, Charity XYZ determined that its cost of operating and maintaining its Web site for the year was $18,000. Accordingly, Charity XYZ reported the following on Schedule I of Form 990-T:

Gross income from exploited exempt activity	***$10,000***
Directly connected expenses	***-8,000***
Net income from unrelated trade or business	***$ 2,000***
Gross income from activity that is not unrelated business income	***15,000***
Attributable expenses	***-18,000***
Excess exempt expenses	***$ 2,000***

Cost Allocation

Accumulation and allocation of unrelated business income expenses related to an organization's Web site is a potentially complex undertaking. A Web site may at once embody various aspects of publishing, fundraising, merchandising (e-commerce), teaching and more. As a general rule, we recommend that, where possible, income and expenses connected with Web site activities that are merely part of a larger "bricks and mortar" activity carried on by an organization -- such as merchandising or fundraising -- be reported as part of that larger activity. However, we do believe that cost allocation relating to Web site advertising should be specifically addressed, as Web advertising is an activity for which existing allocation rules may not be adequate. The IRS Exempt Organization Guidelines, Internal Revenue Manual section 720(7), allow organizations to use any consistently applied, reasonable method in calculating expenses related to online UBIT activities. Additionally, although the focus below is on allocation of costs in connection with advertising activities, we think that the concepts presented are equally applicable to other online UBIT activities.

Advertising Cost Allocation for Non-Periodical Web Pages

For those Web pages that clearly contain advertising -- defined as messages (with or without hyperlinks) containing qualitative or comparative language; price, value or savings information; or an inducement to buy -- we think that exempt organizations should be able to use any reasonable method to allocate costs (including overhead) associated with online advertising revenues. Unlike printed publications, Web sites vary widely in purpose, content, and design, making expense allocation a highly facts-and-circumstances-based calculation. Accordingly, a "one size fits all" approach to expense allocation would be neither a fair nor a workable solution.

However, it would be helpful if, in addition to permitting the use of any reasonable method, the IRS formulated several acceptable allocation methods for exempt organizations to follow, as was done in the regulations under section 162 for allocating costs to lobbying activities.

Some suggested methods follow:

- A cost allocation method similar to that used by printed periodicals under reg. sections 1.512(a)-1(d) and (f). These rules would need to be modified somewhat, due to the unique nature of Web pages (see "Cost Allocation for Web Pages Qualifying as Periodicals").

- A variation of the "gross-up" method used by trade associations and business leagues to accumulate lobbying expenses. This approach might be particularly useful because the costs associated with updating and maintaining an existing Web site are largely labor-based. While the addition of advertising content to a print publication results in added incremental costs -- paper, ink, labor, and possibly increased distribution costs -- additions and changes to a Web site generally do not result in additional incremental costs other than labor. This is because most Web hosting services charge a flat rate on a monthly, quarterly or annual basis for a specific amount of server space.

- A method based on the "simplified service cost method" of reg. section 1.263A-1(h). Although as employed by the regulations under section 263A, this method actually calculates costs that are required to be capitalized, rather than expensed, the method itself -- more specifically, the labor-based allocation ratio -- could easily be adapted for use by exempt organizations to allocate costs associated with Web page advertising. The following is an example of how the ratio could be adapted:

$$\text{Web site costs + allocation of overhead} \times \frac{\text{Online advertising labor costs}}{\text{Total organization labor costs}} + \text{Third party advert. costs} = \text{Direct online advert. costs}$$

"Web site costs" would be defined as the total costs incurred during the taxable year to maintain the organization's Web site, and would include, but would not be limited to, Web hosting charges, domain name fees, labor costs attributable to Web page design and maintenance, specialized software costs, and Internet connection fees (T-1, DSL, dialup, etc.). The definition would also include an allocation of overhead costs.

- Alternatively, the calculation could be based on a ratio of advertising labor hours to total labor hours, as follows:

$$\text{Web site costs + allocation of overhead} \times \frac{\text{Online advertising labor hours}}{\text{Total organization labor hours}} + \text{Third party advert. costs} = \text{Direct online advert. costs}$$

- For those organizations utilizing a third party Webmaster to operate and maintain their Web sites, use of gross-up, labor costs or hours to allocate costs would not be appropriate. Instead, a determination should be made of how much of the Webmaster's fee relates to advertising-related activities. Such an allocation might be made as follows:

$$\text{Internal Web site costs + allocation of overhead} \times \frac{\text{Webmaster advertising costs}}{\text{Total Webmaster costs}} + \text{Webmaster advert. costs/other advert. costs} = \text{Direct online advert. costs}$$

Advertising Cost Allocation for Web Pages Qualifying as Periodicals

Informally, the IRS has alluded to the possibility that certain online publications may be characterized as periodicals, and that use of the cost allocation rules under reg. sections 1.512(a)-1(d) and (f) might be permitted. It is our view, as stated previously, that most of the information presented on an exempt organization's Web site does not fit the "publication" or "periodical" definition, and therefore, should not be limited to use of the more restricted periodical cost allocation rules under reg. sections 1.512(a)-1(f).

Nevertheless, there may be circumstances under which all or a portion of an organization's Web site might be considered to be a publication, or even a periodical. For example, an organization may make an exact copy of its printed periodical or other printed publication available on its Web site using PDF or other similar format. Alternatively, an organization might devote a specific subsection of its Web site to a series of pages showcasing its current publications -- perhaps providing the full text of one or two articles. Under these circumstances, we feel it would be reasonable to treat

those particular Web pages as part of the periodical from which they are derived. We further think it would be most efficient if the online and print versions of the periodical could be reported together as if they were one activity, or at the very least reported together in the "consolidated" portion of Schedule J.

For purposes of this discussion, a Web page is defined as the information (text and graphics) that appears on a user's computer screen when a user types a Uniform Resource Locator (URL) address, such as http://aicpa.org/webtrust/execsumm3.htm into the command line of a Web browser. Each page has its own unique URL. Although most hyperlinks take a user to a separate Web page, some just change the portion of the same Web page that is visible to the user. Web pages vary in length and often contain considerably more information than is visible on a computer screen at any one time.

It is our view that the cost allocation method under reg. sections 1.512(a)-1(f) used for advertising in exempt organization periodicals would require modification before it could be used for Web-based periodicals. For example, Web pages are not uniform in size, and most Web ads are relatively small in relation to the size of the page on which they are displayed. Additionally, the total number of pages on a given organization's Web site can vary from day to day, depending upon how frequently the site is updated, and whether the Web site has the capability of generating "temporary pages" that may or may not contain advertising. Accordingly, should the IRS adopt this approach, we recommend the following:

- All Web pages could be deemed to be one uniform size, regardless of actual size, owing to the difficulty of measuring actual page size (which for any given Web page can vary, depending upon screen resolution, the type of browser used, and browser settings).

- All advertisements residing on a page should be deemed to occupy a specific minimum amount of page space, *e.g.,* 1/8 of a page, owing to the difficulty of measuring ad size in relation to Web page size.

- "Floating" ads (ads that either drift across the Web page or open up in a small pop-up window) should be counted as part of the page that generated them.

- In determining the ratio of ad pages to total pages, total Web page counts should be restricted only to those pages that comprise the on-line periodical; all other organization Web pages should be omitted from the page count. Additionally, if pages featuring back issues, archive articles and other online information not typically found in a print publication are not carrying advertising, they should be omitted from the total Web page count because these online archives tend to be voluminous and extensive. Correspondingly, the cost of maintaining pages not included in the count should not be included either in direct advertising costs or in "readership" costs.

- Unique Internet-related costs allocated through an ad page/total page ratio should include, but not be limited to, the following: Web hosting charges, domain name fees, labor costs attributable to Web page design and maintenance, specialized software costs, and Internet service provider fees (T-1, DSL, dialup, etc.).

- Costs attributable to Web page design and maintenance should be allowable as current period expenditures, similar to the treatment of research and experimental expenditures under section 174(a) or self-developed software, for which section 174 treatment is permitted.

- Certain costs may be shared by both the print and online versions of an exempt organization's periodical, and thus should be allocated between the print publication and the online publication, where appropriate. These costs may include, but should not be limited to, the following: editorial staff labor costs, ad design and layout (where ads are shared between print and online versions), advertising staff labor costs (including commissions paid), subscription and fulfillment costs. Allocation of these costs should be allowed using any reasonable method.

- An appropriate allocation of overhead costs should be permitted, based upon a reasonable method, such as labor costs or hours.

- Allocation of circulation income should be made only if the online periodical is viewable solely by paying members and other subscribers. If the entire publication is viewable by the general public at no charge, then no allocation of circulation income should be made. If a portion of the online periodical is viewable to the public at no charge, then circulation income should be allocated only to that portion of the publication visible exclusively to members and subscribers.

- "Readership costs" for an online publication should consist of costs allocable to the editorial content of the periodical, including unique Internet-related costs as outlined above and an allocation of shared print/online costs, as outlined above.

Political and Lobbying Activities

What facts and circumstances are relevant in determining whether information on a charitable organization's Web site about candidates for public office constitutes intervention in a political campaign by the charitable organization or is permissible charitable activity consistent with the principles set forth in Rev. Rul. 78-248, 1978-1 C.B. 154, and Rev. Rul. 86-95, 1986-2 C.B. 73 (dealing with voter guides and candidate debates)?

Charitable organizations described in section 501(c)(3) may not intervene in political campaigns and may only attempt to influence legislation as an insubstantial part of their activities. Private foundations may do neither. If the charitable organization makes an

election under section 501(h), an expenditure test is applied in determining whether the organization has engaged in substantial lobbying activities, with different limits applicable for direct and grassroots lobbying. Notwithstanding a change in the medium by which the message is communicated, it is our position that existing law, regulations, rulings, and court decisions remains applicable. Additionally in addressing the utilization of the Internet by charitable organizations in the context of political and lobbying activities, the governing principle should be freedom of expression, as provided for in the Constitution.

However, new rules must be adopted to stipulate the circumstances, if any, under which the exempt organization is responsible for the message contained on a linked Web site. As set forth in the Agency Responsibility section of these specific comments, in answer to the IRS question, an organization should only be held responsible for the contents on its own site over which it has control. Further it is the motivation for placing a hyperlink of its site that determines the character of the action, not the content of the linked site. As suggested above in our comments on contemporaneous documentation of process, an organization should only be held responsible for the contents on its own site over which it has control.

With the foregoing principles in mind, Rev. Rul. 78-248 should be updated to include the following Internet situations:

> *Situation One* - Consistent with the mere posting on a charitable organization's Web site of a compilation of voting records of all members of Congress (or of any legislative body) on major legislative issues involving a wide range of subjects, devoid of editorial opinion, is not prohibited political activity. This presumes that the contents and structure do not imply approval or disapproval of any member's voting record.
>
> *Situation Two* -The utilization of an email questionnaire and an email response that results in those responses being posted on an organization's Web site should not constitute political activity if the conditions set forth in the ruling are present.
>
> *Situation Three* - Whether the medium is print or electronic, if the questions posed evidence a bias on certain issues, the result should be the same-prohibited political activity.
>
> *Situation Four* - We are not commenting because we disagree with its conclusion, and believe that the issues raised transcend Internet issues.

With respect to Rev. Rul. 86-95, the principles set forth could be expanded to provide that scheduled public forums involving qualified candidates for political office may be conducted on the Internet. If an impartial moderator(s) is utilized as a means of encouraging unbiased treatment of candidates, and the discussion does not promote or advance one candidate over another, such activity would not constitute political campaign intervention. Moderators should be expected to screen questions and assure all the

candidates participating are treated fairly. We believe that Federal Election Commission Advisory Opinion 1999-25's conclusion that the Internet activity of two section 501(c)(3) organizations constituted "nonpartisan" activity is equally applicable to the Internal Revenue Code's prohibition against intervention in political campaigns. Thus, such activity would constitute educational activity within the purview of Rev. Rul. 86-95.

Does providing a hyperlink on a charitable organization's Web site to another organization that engages in political campaign intervention result in *per se* prohibited political intervention? What facts and circumstances are relevant in determining whether the hyperlink constitutes a political campaign intervention by the charitable organization?

As a fundamental principle, an organization is not responsible for the content on a linked site as described above. Rather, a hyperlink is analogous to a telephone number that enables the caller to access information. Simply including links to candidate and/or political party Web sites should not be treated as political campaign intervention. In the absence of partisan language and/or graphics, or limiting access to opposing candidates, or parties, such links should not be deemed to be support for a candidate or party, unless the motivation for placing the link is to advance the candidacy.

The IRS EO CPE Text for FY 2000 (Chapter S-Affiliations Among Political, Lobbying and Education Organizations) is relevant. It states that section 501(c)(3) organizations cannot establish a section 527 organization to conduct political intervention activities that it could not directly conduct. Under this view, a hyperlink from a section 501(c)(3) organization to a section 527 organization would be per se campaign intervention. However, IRS Notice 88-76, 1988-2 C.B. 392 (Announcement 88-114, 1988-37 I.R.B. 26), provides that a section 501(c)(3) organization can establish a section 527 organization solely to conduct exempt functions that would qualify as lobbying under section 501(c)(3) (i.e., attempting to influence the selection of a federal judge). In the latter scenario, a hyperlink would not be per se political intervention if the section 501(c)(3) organization establishes a section 501(c)(4) organization in a manner described in *Regan v. Taxation with Representation*, 461 U.S. 540 (1983), to conduct lobbying activities, as well as an insubstantial level of political activities.

For charitable organizations that have not made the election under section 501(h), what facts and circumstances are relevant in determining whether lobbying communications made on the Internet are a substantial part of the organization's activities? For example, is the location of the communication on the Web site (main page or subsidiary page) or number of hits relevant?

To determine whether a charitable organization has engaged in substantial lobbying activity, the content displayed on its Web site and other electronic communications should be taken into consideration. The frequency and volume of email communications, the proportion of the organization's Web site devoted to legislative matters, the prominence of lobbying information, the organization's motivation in publishing the information, the impartiality of the information, and attempts to publicize the site should

be considered. Information disseminated on a site should be evaluated using existing rules. We suggest Part VI-B of Schedule A be revised to include references to electronic communications as follows:

- Mailings to members, legislators, or the public in print and/or electronic media.

- Publications, or published or broadcast statements, including the Internet.

Does providing a hyperlink to the Web site of another organization that engages in lobbying activity constitute lobbying by a charitable organization? What facts and circumstances are relevant in determining whether the charitable organization has engaged in lobbying activity (for example, does it make a difference if lobbying activity is on the specific Web page to which the charitable organization provides the hyperlink rather than elsewhere on the other organization's Web site)?

If the link is viewed as the equivalent of a telephone call, there should be no attribution. Lobbying messages contained on a page other than the linked page should similarly not be attributed to the Host Organization. The concepts expressed in reg. section 53.4945-2(a)(7) should apply. A private foundation is not deemed to conduct lobbying activity when it makes a grant to a public charity that lobbies as long as it does not earmark its grant for lobbying. As long as the charitable organization's Web site contains no endorsement, nor highlights of the information on the linked site in some "extraordinary" way, the activity of the other organization should not be attributable to the charity. Although not necessarily required, a safe harbor could be adopted that requires the charity's site contain an advisory with respect to the linked site's lobbying activities not reflecting the opinion of the organization. Alternatively an organization might require that access to the linked site contain a consent button link.

To determine whether a charitable organization that has made the election under section 501(h) has engaged in grass roots lobbing on the Internet, what facts and circumstances are relevant regarding whether the organization made a "call to action?"

Reg. section 56-4911-2(b)(2)(ii) sets forth the required elements for a communication to be treated as a grass roots lobbying communication. Amongst the required elements is that the communication "encourages the recipient thereof to take action." The term, "encourages the recipient to take action" is defined in reg. section 56.4911-2(b)(2)(ii). We believe the foregoing rules are equally applicable to the Internet environment. We further believe that each of the required elements must be present within the context of a particular Web page or email message for there to be a "call to action."

Does publication of a Web page on the Internet by a charitable organization that has made an election under section 501(h) constitute an appearance in the mass media? Does an e-mail or listserv communication by the organization constitute

an appearance in mass media if it is sent to more than 100,000 people and fewer than half of those people are members of the organization?

Reg. section 56-4911-2(b)(5)(iii) provides special rules for "mass media" advertisements. As written, the regulations define "mass media" to include television, radio, billboards and general circulation newspapers and magazines. While mindful that the regulations predate the Internet, we believe that, in the absence of an amendment to the regulations, the general rule should be that the "mass media" recharacterization rule should not apply to an organization's Internet communications. However, to the extent that a portion of an organization's Web site constitutes a "periodical" (see discussion in response to Question 1), the "mass media" recharacterization rule should apply. In keeping with our position that reg. section 56.4911 et seq. is applicable to the Internet, the rules of this section, including reg. section 56-4911-2(b)(5)(iii)(A), relating to the member exception where the total circulation is greater than 100,000, are equally applicable.

What facts and circumstances are relevant in determining whether an Internet communication (either a limited access Web site or a listserv or e-mail communication) is a communication directly to or primarily with members of the organization for a charitable organization that has made an election under section 501(h)?

Reg. section 56.4911-5(e) provides operative rules for determining whether "written communications" are designed primarily for members of an organization. In determining whether a communication (which is not directed only to members) is designed primarily for members of an organization, reg. section 56.4911-5(e)(1) states that a communication is primarily for members "if more than half of the recipients of the communication are members of the organization."

Reg. sections 56.4911-5(f)(1)(i), (ii) and (iii) define a person as a member of an electing public charity. In addition, a person not a member of an electing public charity within the meaning of reg. section 56.4911-5(f)(1) "may be treated as a member of an electing public charity if such organization can demonstrate to the satisfaction of the IRS that there is a good reason for its membership requirements not meeting the requirements of reg. section 56.4911-5(f)(1), and that its membership requirements do not operate to permit an abuse of the rules described in this section." Consistent with our previously stated position that existing legal authority should remain applicable to Internet activities of exempt organizations, we believe the foregoing cited regulations are equally applicable in determining whether Internet communications are member directed within the purview of the above-cited regulations.

Applicability of UBI Exceptions

To what extent are business activities conducted on the Internet regularly carried on under section 512? What facts and circumstances are relevant in determining whether these activities on the Internet are regularly carried on?

Due to its constant availability, the Web site itself and its display that is capable of being constantly viewed would be treated as a regular activity. Discrete and periodic activities, if conducted for a brief period, the typical seasonal or one week effort, should be treated as an irregular activity within the site.

Are there any circumstances under which the payment of a percentage of sales from customers linked by the exempt organization to another Web site would be substantially related under section 513?

Yes. When the exempt organization's link specifically refers to a related item, such as a school textbook sold to a student, the revenue should be treated as related since the sale of the same book by the exempt organization itself would be related. If the link to a commercial book distributor is not specifically associated with related items, the income would be unrelated as discussed above under "The Nature of Links."

In addition, existing rules with regard to the "convenience" exception in section 513(a)(2) should apply, as well as other exclusions such as the royalty exclusion (section 512(b)(2), as discussed above), the bingo exclusion (section 513(f)), the donated goods exclusion (section 513(a)(3)), and the unpaid labor exclusion (section 513(a)(1)) modifications.

New Exemption Issues -Virtual Organizations

A challenging new issue for the IRS is the potential qualification for exemption of nonprofit organizations whose activities are conducted solely on the Internet. As stated in our general comments, we believe the Internet is merely a new medium of communication and that substantially online activities can be evaluated by the existing rules pertaining to offline activities. We submit the two following examples in support of our conclusion. We submit the two types of organizations – trade shows and churches – as examples in support of our conclusion.

Virtual Trade Shows

Are there any circumstances under which an online "virtual trade show" qualifies as an activity of a kind "traditionally conducted" at trade shows under section 513(d)?

Yes, as discussed below.

Statutory Construction of Section 513(d)

Section 513(d) of the Code states that the term "unrelated trade or business" does not include qualified convention and trade show activities. The statute goes on to state that the term "trade show activity means any activity of a kind traditionally conducted at...trade shows." This construction requires an examination of the kind of activities conducted at a trade show to determine if the activities are traditional in reference to other trade shows. The construction does not require an examination of the kind of trade

show being conducted, nor the time or location of the trade show being conducted, only the activities being conducted there.

The statute does not define what a trade show is, where it must take place, or whether there are physical location requirements necessary in order for activities to constitute a trade show. Reg. section 1.513-3(c)(3) defines a trade show as an event that is held in conjunction with "an international, national, state, regional, or local convention, annual meeting, or show." This definition, such as it is, certainly does not exclude an Internet Web site location from qualifying as a trade show under the statute and regulations. We believe that it also does not exclude the possibility that an Internet trade show could be held in conjunction with a "virtual" convention, annual meeting, or show. And, while the phrase "in conjunction with" does imply a limit on the trade show's length, we believe that an Internet trade show might be subject to different standards with regard to length, especially if it is held in conjunction with a "virtual" convention or show, or otherwise serves the organization's exempt purposes. We believe that the unique educational advantage that an Internet trade show would offer, combined with a reasonable standard for show length, serve as a general rule for the length of time that a "virtual" trade show may run.

In our view, the controlling issue of whether an Internet trade show qualifies under section 513(d) should be whether the kind of activities that take place at an Internet trade show are traditional as compared to other trade shows. Reg. section 1.513-3(c)(4) defines trade show activity as "any activity of a kind traditionally carried on at shows" including "activities designed to attract to the show members of the sponsoring organization, members of an industry in general, and members of the public, to view industry products or services and to stimulate interest in, and demand for such products or services." Where the activity at an internet trade show includes surveying the depictions of goods and services provided to a particular industry, seeking selling and marketing options and opportunities, interacting with other customers, prospects, and vendors, and accessing news, information, and educational materials pertinent to a particular industry, the activity should be considered traditional because such activities are designed to stimulate the industry. Activities designed to stimulate the industry that take place at physical trade show locations can also occur at an Internet location and provide an equally stimulating forum where many members of an industry can participate in activities traditionally conducted at trade shows.

On the other hand, where a trade show does <u>not</u> contain news, educational materials, and other pertinent industry information, connections, and contacts, and other activities traditionally conducted at trade shows, doubts may be raised as to whether it qualifies as a trade show under the statutes. When an Internet site includes <u>only</u> selling activities, and nothing more, then it clearly should not fall under the section 513(d) exemption. For example, a site listing only vendor contact information and nothing more should not constitute a trade show under the statutes. Likewise, when a trade show includes activities and features such as auctions, commissions or fees on sales, charges to show participants based on usage or click-throughs, then the purported trade show is engaged in activity that more closely resembles a retail facility or marketplace rather than a trade

show. Such activities might run afoul of section 513(d) because they do not meet the statutory directive of being activities of a kind traditionally conducted at trade shows.

However, it is important to note that sales and order taking, as a component of any trade show, do not violate section 513(d). The history of section 513(d) clearly indicates that sales activities help advance the purpose of organizations in promoting and stimulating interest in and demand for industry products and services. See generally, General Explanation of the Tax Reform Act of 1976 [H.R. 10612, 94th Congress, P.L. 94-455]. Congress emphatically deposed the Service's then prevailing notion that UBIT was created by the mere presence or tolerance of sales activity at a trade show. Section 513(d) essentially allows sales to occur at any trade show without inviting the UBIT penalty. In other words, activity of a kind traditionally carried on at trade shows unarguably includes sales activity. Therefore, the presence of sales activity at an Internet trade show cannot, without other activities, disqualify a trade show under the statute.

History of Section 513(d)

The legislative history of section 513(d) reveals no definition or exemplification of the meaning of "traditionally" as used in that section. The legislative history indicates that section 513(d) was intended to supersede a series of revenue rulings issued by the Service in 1975 ("the 1975 rulings"). See generally, General Explanation of the Tax Reform Act of 1976, supra. In the 1975 rulings, the Service ruled that income that exempt business leagues received at their trade shows from renting display space constituted unrelated business taxable income because sales by the exhibitors were permitted or tolerated at the shows.

The record reflects Congress' belief that the sales activities at trade shows in the 1975 rulings were related to the exempt purposes of the organizations conducting them. Congress noted that trade associations use their trade shows as a means of promoting and stimulating an interest in, and demand for, their industries' products in general. Furthermore, Congress came down squarely against the Service's then current position that any sales activity occurring at a trade show rendered the show a retail facility. Therefore, the section 513(d) exemption was intended to remedy the position of the 1975 rulings that held that any sales, or even the possibility of sales, resulted in UBIT. If the UBIT rules are not invoked when sales occur at a brick and mortar trade show, then it logically and undoubtedly follows that sales, or the possibility of sales, at an Internet trade show should not invoke the UBIT rules.

According to the House Reports, Congress was concerned about unfair competition between exempt organizations and taxpaying entities, and did not indicate a concern about the means used by an organization to promote an interest in and demand for an industry's products. Congress submitted that sales activities at a trade show do not render a trade show a retail facility because sales are but one activity that promotes and stimulates interest in and demand for industries' products in general. Since the presence of sales activity at a physical trade show does not alone invoke the unrelated business income tax, the fact that sales may take place via the Internet trade show should cannot preclude a finding that the activities taking place at an Internet trade show are activities that are traditionally conducted at a trade show.

Internet Trade Shows Operate to Further a Trade Association's Tax-Exempt Purpose

Before section 513(d) was enacted, trade show activities were generally exempt from the unrelated business income tax (UBIT) because such activities were considered substantially related to the performance of a trade association's tax-exempt purpose. Neither the legislative history of section 513(d) nor the express language of the statute indicates that Congress sought to negate the substantially related analysis by which trade show activity has always been exempt from UBIT. On the contrary, Congress was concerned about the potential misuse of trade shows by transforming activity conducted to further a tax-exempt purpose into primarily sales activity.

With these understandable Congressional concerns in mind, a justifiable examination of Internet trade show activities should focus on the manner in which the activities are conducted and whether those activities are substantially related to a trade association's exempt purpose. The timely dissemination of educational information, new rules and regulations, and information on changing technology affecting an industry is precisely the type of activity that serves the interests of an association's members and furthers the exempt purpose of an association.

Such information is received and shared at physical trade shows for a very short period of time, usually for a few days, on an annual basis. During the time that elapses between physical trade shows, information that was once relevant may become obsolete. To remedy the problem of obsolescence, and in furtherance of an association's tax-exempt purpose to provide stimulation and education with respect to an industry, information can be transmitted, received, and shared instantaneously via an Internet trade show, substantially increasing the usefulness of industry information. Moreover, information obtained from an Internet trade show can be periodically and conveniently updated and, within reasonable constraints of show length permitted to a trade show with an Internet venue, can help ensure that Internet trade show participants receive the latest and most accurate information with respect to an industry, thereby furthering an exempt purpose by promoting, educating, and benefiting an entire industry.

Virtual Churches

Robert Harper Jr., Manager, Technical (Rulings) Group 3, IRS Tax Exempt/Government Entities Division, said at the Fall 2000 Symposium that the IRS is considering whether an online church could qualify for exempt status. Based upon the principles outlined below, we believe a church that conducts its activities solely on the Internet can meet a majority of the factors on the 14-point test so as to qualify as a "church" (as that term is used in the Code).

An organization qualifies as exempt from taxation under section 501(c)(3) if it meets the following requirements:

- It is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes;

- No part of its net earnings inure to the benefit of any private shareholder or individual;

- No substantial part of its activities are for carrying on propaganda or otherwise attempting to influence legislation; and

- It does not participate or intervene in any political campaign for or against a candidate for public office.

With respect to private foundation status, section 509(a)(1) provides that certain organizations described in section 170(b)(1)(A) will not be considered private foundations, including "churches." The IRC and regulations do not define "church." However, the IRS recognizes certain characteristics of a church, relevant in determining whether an organization qualifies as a church under section 170(b)(1)(A), including the following:

- A distinct legal existence
- A recognized creed and form of worship
- A definite and distinct ecclesiastical government
- A formal code of doctrine and discipline
- A distinct religious history
- A membership not associated with any other church or denomination
- An organization of ordained ministers
- Ordained ministers selected after completing prescribed courses of study
- A literature of its own
- Established places of worship
- Regular congregations
- Regular religious services
- "Sunday schools" for the religious instruction of the young
- Schools for the preparation of its ministers.

See *American Guidance Foundation*, 490 F. Supp. 304 (D.D.C. 1980); IRM 7752, Ch. 200; and draft Publication 1828. These characteristics were first announced by a former Commissioner in a 1978 speech. See *Foundation of Human Understanding v. Commissioner,* 88 TC 1341 (1987), footnote 6, acquiescence in result. The Internal Revenue Manual provides that a "church" must: (1) have a body of believers that assembles regularly in order to worship, and (2) be reasonably available to the public in its conduct of worship, educational instruction, and promulgation of doctrine. IRM 7752, Chapter 200 citing *American Guidance Foundation,* supra.

Courts continue to debate and adopt varying definitions of a church including the following:

- "A church is a coherent group of individuals and families that join together to accomplish the religious purposes of mutually held beliefs. In other words, a

[church must]... assemble regularly a group of individuals related by common worship and faith." *Church of Eternal Life v. Commissioner*, 86 TC 916 (1986).

- "While some of [the characteristics listed above] are relatively minor, others -- e.g., the existence of an established congregation served by an organized ministry, the provision of regular religious services and religious education for the young, and the dissemination of a doctrinal code -- are of central importance." *American Guidance Foundation,* supra.

- "The word 'church' implies that an otherwise qualified organization brings people together as the principal means of accomplishing its purpose. The objects of such gatherings need not be conversion to a particular faith or segment of a faith nor the propagation of the views of a particular denomination or sect. The permissible purpose may be accomplished individually and privately . . . but it may not be accomplished in physical solitude." *Chapman v. Commissioner,* 48 TC 358 (1967).

Some courts chose to adopt the fourteen point test listed above, while others do not. See *American Guidance Foundation* and *Foundation of Human Understanding*, supra.

An organization conducting activities solely on the Internet could possess most, if not all, of the above listed characteristics. For illustrative purposes, let us assume that an organization exists that is organized under the nonprofit corporation laws of a given state. This organization is named "The Virtual Christian Church" (the "Church"). The Church engages in daily religious services based on Christianity where members of the Church initially sign-in giving their name and whether they visited the Church before. Once sign-in is complete, the participant enters a room on the Web site that lists all participants in attendance and provides a real-time sermon by one of the Church's ministers in text form, much like a chat room. The Church has one dedicated minister, but other ministers that belong to other brick and mortar churches across the country volunteer to conduct services for the Church. Like an offline church service, participants interact with and respond accordingly with the minister via real-time messaging (e.g., responding "Amen" when appropriate). Also like other churches, membership is open to the public, but the Church has a distinguishable membership as evidenced by the participation of the same individuals on a regular basis. Of course, the Church's members are free to attend other churches, but the Church believes it has established an Internet community of members. The Church even has an interactive section of its Web site intended to teach Christian ideals to younger individuals.

Let us assume the Church meets the organizational and operational tests, as well as the prohibition against inurement, substantial lobbying and political activities. The Church also has a distinct legal existence as a nonprofit corporation under state law. Further, the Church, with Christianity as its foundation, has a recognized creed and form of worship as evidenced by the services conducted, a formal code of doctrine and discipline based on Christian teachings, a distinct religious history of Christianity, a literature of its own, regular congregations, and regular religious services. Arguably, the members are not

worshiping in solitude, akin to praying. Rather, the Church's members are congregating and associating with others online.

The virtual Church illustrates again that the Internet provides organizations with a **new way** to conduct activities, not necessarily **new activities**. In the case of the virtual Church, however, instead of the logical parallel being to another medium like broadcast or print, the logical parallel is to the brick and mortar churches. Like the church with four walls, it is possible for an organization conducting its activities solely on the Internet to possess, if not all of the characteristics of a church, at least the characteristics identified by some authorities as more significant in this determination. We are not commenting on the appropriateness of the characteristics the IRS or the courts have identified to define a church. Rather, the AICPA asserts that, given the existing standards, an organization should not be denied status as a Church merely because it conducts its activities solely on the Internet. Although some cannot envision such a personal activity as worship taking place on the Internet, we should remember that the Internet has proven to be an area where people are conducting many personal activities, including shopping, banking, and even dating.

The main difference between the Church described above and what is thought of as a more traditional church is the fact that the latter typically has four walls and a roof. This difference alone should not deny an organization status as a church.

Solicitation of Contributions

There are numerous Code provisions regulating the solicitation and receipt of charitable contributions. For example, exempt organizations not eligible to receive tax-deductible charitable contributions under section 6113 are required to disclose, in certain solicitations for contributions, that such contributions are not deductible for Federal income tax purposes as charitable contributions. Charitable organizations that receive certain "*quid pro quo*" contributions in excess of $75 are required under section 6115 to provide a written statement to the donor that indicates that the charitable deduction is limited to the amount paid by the donor in excess of the value of the goods or services provided by the organization and provide a good faith estimate of that value. Under section 170(f)(8), donors making contributions of $250 or more to a charitable organization must substantiate the contribution with a contemporaneous written acknowledgement from charitable organization in order for the deduction to be allowed.

An increasing number of exempt organizations solicit contributions on the Internet. In some instances, the organization's Web site merely indicates an address for sending contributions to the organization. In other cases, the organization is able to accept contributions on the Internet, either directly or through a third party that provides a secure connection for credit card transactions. Our responses to the services questions follow:

> **Are solicitations for contributions made on the Internet (either on an organization's Web site or by email) in "written or printed form" for purposes of section 6113? If so, what facts and circumstances are relevant in**

determining whether a disclosure is in a "conspicuous and easily recognizable format?"

Does an organization meet the requirements of section 6115 for "*quid pro quo*" contributions with a Web page confirmation that may be printed out by the contributor or by sending a confirmation email to the donor?

Does a donor satisfy the requirement under section 170(f)(8) for a written acknowledgment of a contribution of $250 or more with a printed Web page confirmation or copy of a confirmation email from the donee organization?

The IRS should issue an announcement to provide that disclosures regarding deductibility of payments to tax-exempt organizations required pursuant to the following Internal Revenue Code sections can be made electronically by way of computer-based communications on a tax-exempt organization's Web site and with an e-mail message. A message containing the required language and display, in printable form on the Web page or transmitted by e-mail, should be treated as adequate documentation for tax purposes.

Section 170(f)(8) – The Charitable Receipt Rule

No charitable deduction is allowed for a gift of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization with sufficient information to evidence the amount of the deductible contribution in accordance with rules set out in reg. section 1.170A-13. Separate payments during a year are not aggregated; only a single payment of $250 or more requires substantiation. The acknowledgment must be written and contain the following information:

- Amount of cash the taxpayer paid and a description (but not necessarily the value) of any property other than cash the taxpayer transferred to the donee organization;

- A statement of whether or not the donee organization provided any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization; and

- If the donee organization provided any intangible religious benefit, a statement to that effect.

- The existing regulations prescribe no specific format for the written acknowledgment and the information is not filed either by the charity or the donor. The requirement is simply to produce documentation to substantiate the claimed donation. Internet display or e-mail transmission of the acknowledgment in printable form will enable the donor to satisfy the documentation requirement. The display must be timed to assure that the receipt be obtained before the taxpayer files a return claiming a deduction for the gift.

Section 6115(a) – The Quid Pro Quo Disclosure Rules

When an organization described in sections 170(c)(2), (3), (4), or (5) receives a *quid pro quo* contribution in excess of $75, the organization shall, in connection with the solicitation or receipt of the contribution, provide a written statement that contains the following information:

- Informs the donor that the amount of the contribution that is deductible for Federal income tax purposes is limited to the excess of the amount of any money and the value of any property other than money contributed by the donor over the value of goods or services furnished in return, and

- Provides a good faith estimate of the value of such goods or services.

A quid pro quo contribution is "a payment made partly as a contribution and partly in consideration for goods or services provided to the donor by the donee organization." Such quid pro quo solicitations should be allowed via a Web site or e-mail message so long as the required disclosures are displayed thereon.

Section 6113 – The Non-Charitable Organization Disclosure

Funding solicitations of social welfare organizations exempt under section 501(c)(4); labor, agricultural, and horticultural organizations exempt under section 501(c)(5); business leagues exempt under section 501(c)(6); and section 527 political organizations whose gross annual receipts exceed $100,000, must state on solicitations that:

- The solicitation for dues, donations, and other payments must include an express statement that it is not a charitable organization described in section 170(c) eligible to receive deductible charitable contributions;

- The statement must be at least the same type size as the primary message, and is readily visible against the background of the page;

- The statement must appear on the same page as, and in close proximity to, the actual request for funds. On a Web page, the notice must appear before the "submit" or other button to activate payment procedures; and

- The statement is either the first sentence in a paragraph or constitutes a paragraph.

IRS Notice 88-120, 1988-2 C.B. 454 requires that the telephone, radio, and television solicitations also contain such a disclosure and directs an organization soliciting funds in this manner to keep a copy of the script of the broadcast to evidence compliance. Similarly an organization would print the page on the Web site and the e-mail to provide evidence.

The penalty for failure to make the section 6113 disclosure is $1,000 a day for each day on which the failure occurs, up to a maximum of $10,000. The day on which the e-mail message is "sent" and the day on which the language is posted for public display on an organization's Web site should be considered the day on which the disclosure began for calculating the penalty.

Sections 162(e)(4) and 6033(e)(1)(A) – The Lobbying Expenditure Disclosure

Dues paid to IRC sections 501(c)(4), (5), and (6) organizations are not deductible to the extent the money is spent on specific types of lobbying activity. Such organizations may either (1) inform their members of the portion of their dues so expended that are not, therefore, deductible or (2) allow members to consider the dues payments as deductible business expenses and pay a proxy tax equal to 35% of the expenditures.

IGive.com Sites

Online donation sites, such as Shop2Give.com and 4charity.com allow one to "donate" a portion of their purchases to a charity. Another version of this type of fundraising is electronic script as discussed by Michael Seto and Dave Jones, "Fund-Raising Issues, Part II, Script Programs," Chapter T, IRS Fiscal Year 1999 Exempt Organization Technical Instruction Program. The issue is what is the character of donations received from such cause-related sites. If it is a non-*quid pro quo* transaction in which the charity performs no services and provides no goods, the revenue could be treated as a contribution. If the payment is not a donation but the recipient charity's role is a passive one, the resulting revenue paid to the charity might represent exempt royalty income from the use of the charity's name. Whether the donor or the charity can consider the payment a donation depends upon the purchaser's motivation. A gift only occurs when the donor makes (or in this case causes) a gift out of disinterested generosity. [section 170(c); *U.S. v. American Bar Endowment*, 477 U.S. 105, 116-117 (1986); *Duberstein v. Commissioner*, 363 S. Ct. 278 (1960); *Allen v. U.S.*, 541 F. 2d 786 (9th Cir. 1976); Rev. Rul. 86-63, 1986-1 C.B. 88; Rev. Rul. 76-232, 1976-2 C.B. 62.] No donation is available to the purchaser when the price the purchaser pays is the same whether or not a donation is made. The seller, however, may be entitled to a charitable contribution.

AICPA COMMENTS ON OTHER INTERNET ISSUES

Corporate Sponsorship Issues

Although IRS Announcement 2000-84 does not address the issue of corporate sponsorship on the Internet, certain questions should be resolved. The proposed regulations on corporate sponsorship (REG-209601-92) make almost no mention of the Internet. There is a strong need for future guidance to address the follow questions:

Are corporate sponsorship rules applicable to Web sites?

Yes. Our position is that these rules should apply to acknowledgements appearing on an organization's Web site unless that Web site (or portion thereof) is considered to be a periodical as discussed above. The mere presence of an acknowledgement in a periodical does not, of itself, result in unrelated business income. The determination of the character of such income should be determined based upon all relevant facts and circumstances.

Does the addition of a hyperlink to the sponsor's Web site cause the sponsorship income to be excluded from qualified sponsorship income?

A hyperlink, in our view, is exactly the same as an address or phone number that is allowed by the proposed regulations to be included in a sponsorship message. Additionally, the proposed regulations do allow a sponsor's message to include an Internet address. As with a mailing address or a telephone number, the provision of a link with the acknowledgement requires a conscious action on the part of the viewer (in this case, a click) in order to access the sponsor's information. Thus, as long as the acknowledgement on the exempt organization's Web site does not contain language or logo material disallowed by the proposed corporate sponsorship regulations, it should *not* cause the related income to be excluded from qualified sponsorship income.

If the link is directly to a commercial portion of a sponsor's Web site, is it then excluded from being qualified sponsorship income?

The destination on the sponsor's Web site should not be determinative in excluding revenue from qualified sponsorship income. Again, in the non-Internet context, the address and telephone number of a sponsor may be provided in the sponsorship acknowledgement message. The reader of such a message often has every expectation that the address is a commercial address where items are offered for sale; likewise, one who calls the phone number of a corporation may expect the phone to be answered by a salesperson. It would be inequitable to place a different standard on an Internet address.

If the fees paid by a sponsor for Web site acknowledgement and accompanying link to the sponsor's Web site are contingent upon the number of hits upon the sponsor's Web site or the dollar value of purchases, can this still be considered as corporate sponsorship?

A sponsorship contingent upon the number of visits to the sponsor's site represents compensation based upon the return benefit to the sponsor. [Proposed reg. section 1.513-4(d)(2)] Such fees do not qualify as non-taxable sponsorship revenue though the revenue may qualify for exclusion from unrelated business income as royalty income under other provisions of the law.

Internet Issues for Section 501(c)(7) Membership Organizations

The development and maintenance of a Web site can further the tax-exempt purpose of section 501(c)(7) membership organizations by bringing members together for a common purpose. The Internet provides clubs an electronic source of keeping members informed and encouraging participation in membership activities. The character of revenues generated on a club's site, however, raises the following questions unique to social clubs.

> **Assume Hyper-links to commercial enterprises are placed on the membership organization's web site that, when activated by the member, advertise and offer to sell non-club products to the member. Are fees received by the club treated as member-related income for purposes of meeting the 15/35 test?**

The income should be classified as member-related. Proposed and withdrawn reg. section 1.277-1 defines the term 'membership income' to include that part of the rental income received from a person in exchange for permitting him to operate a membership organization's facilities. That part of rental income so included in "membership income" is equal to the product of the total rental income, multiplied by a fraction, the numerator of which is the gross income received from members by the operator with respect to such facility, and the denominator of which is the total gross income received by the operator with respect thereto. Clubs may make this allocation if the facility maintains adequate records to identify revenues from members. For example, if the operation of the dining facilities of a membership organization is leased to a concessionaire, and 95 percent of the total gross income for the use of the facilities is from members, then 95 percent of the amount paid by the concessionaire to the organization shall be treated as membership income. Similarly, if a membership organization leases its golf shop to a golf professional, and 97 percent of the total gross income for the use of such facility is from members, then 97 percent of the amount paid to the membership organization by the golf professional shall be treated as membership income. Accordingly, revenues generated from a Web site that can be specifically identified as stemming from a member transaction should be treated as member income.

> **If the hits come from nonmembers visiting the membership organization's Web site, is this income nonmember income?**

It appears that this income would be classified as nonmember income. [Proposed and withdrawn reg. section 1.277-1 as noted above.]

> **Will the commission income received from a commercial entity be deemed to be nonmember income merely from the fact that the income comes from a "nonmember?"**

In our view, this income would be classified as nonmember income. [Proposed and withdrawn reg. section 1.277-1 as noted above.]

If the hyper-link is to a commercial site and the general public has access to the membership organization's site, does an impermissible form of advertising by a section 501(c)(7) organization occur?

Pursuant to Rev. Rul. 65-63, the answer should generally be "no." Public patronage and participation in club activities is permissible when (1) it is incidental to and in furtherance of the club purposes, and (2) the resulting net income does not inure to members as individuals. The activity would disqualify the organization from exemption under section 501(c)(7) if (1) the activity is of such magnitude and recurrence as to constitute engaging in a business, and (2) the club acquires additional assets and pays club expenses normally borne by its members will the resulting revenue.

Bartering Activities

Commercial entities desire access to membership and donor lists of tax-exempt organizations. In return for such access, such businesses provide free Web site design and maintenance to organizations in return for links to the organization's constituents. The commercial enterprise may design the site itself or pay a fee directly to an independent Web site designer based upon the number of clicks coming from the membership organization's site. In such situations, the organization receives a noncash benefit equal to the cost of establishing and maintaining the site. Membership organization sites may be made available as member only pages or pages available to both members and nonmembers. Bartering income, potentially taxable as unrelated income, results from such transactions.

The value of the design and maintenance of its Web site received by an exempt organization in return for allowing access to its membership lists is a bartering transaction resulting in income equal to the value of the work performed. The value is equal to that amount the organization would have had to pay if it contracted with a vendor providing similar services. The transaction is essentially a licensing of the use of the organization's membership lists and, accordingly, the character of the income should be determined under the principles outlined in *Sierra Club v. Commissioner*, 103 T.C. 307 (1994). To the extent that the organization is required to perform services, if any, in connection with promoting the site, a portion of the fee could be treated as unrelated business income.