

# C Legal Issues

## C-1 UNDERSTANDING INTERNAL REVENUE SERVICE RULES

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### C-1.1 Compliance With Current Regulations

The Postal Service is required to be consistent with Internal Revenue Service (IRS) rules in determining whether advertisements for products and services (published in materials of an authorized organization and mailed at the Nonprofit Standard Mail rates) are substantially related to the authorized organization's purposes. IRS rulings and regulations in this appendix may be updated from time to time. If they are updated, these standards will be followed by the Postal Service.

### C-1.2 General Standards

Generally, nonprofit or tax-exempt entities are not subject to tax on income that they receive. An exception exists, however, for any net income received from an unrelated trade or business regularly conducted by the nonprofit entity. See 26 U.S.C. 511.

### C-1.3 Trade or Business Activity

The terms trade and business include any specific activity "which is carried on for the production of income from the sale of goods or the performance of services." 26 U.S.C. 513(c). An activity may be a trade or business even though it is part of a larger group of similar activities that do not generate income.

### C-1.4 Nonprofit Related Activity

According to IRS regulations, a trade or business is "related" to an exempt purpose only if the conduct of the business activity has causal relationship to the achievement of the exempt purpose, other than simply the production of income. 26 CFR 1.513-1(d)(2). The trade or business is "substantially related" if the causal relationship is a substantial one. 26 CFR 1.513-1(d)(2). The IRS describes this as follows:

"Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the

performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.” 26 CFR 1.513-1(d)(2).

### C-1.5 **Size and Extent of Activity**

The size and extent of the activity involved must be considered in relation to the nature and extent of the exempt function. If the activity is related but conducted on a larger scale than necessary, income earned from the excess activity is treated as coming from an unrelated trade or business.

### C-1.6 **Income From Products**

If income from the related trade or business is from the sale of a product, the product when sold must be substantially unaltered upon completion of the exempt function. 26 CFR 1.513-1(d)(4)(ii). If the product is improved, changed, or processed further than necessary for disposition, the income generated is from an unrelated trade or business and thereby not substantially related for postal rules.

Unrelated business income also results if an asset or facility needed for an exempt function is also used for a nonexempt purpose that produces income. 26 CFR 1.513-1(d)(iii).

If the advertisement is for a product that generates income for an unrelated trade or business, the advertisement for the product may not be eligible for mailing at the Nonprofit Standard Mail rates. Thus, the fact that the mailing under examination promotes a product or service entirely created by members of the mailing organization does not automatically qualify the mailing for the Nonprofit Standard Mail rates.

### C-1.7 **Utilitarian Products**

The IRS has articulated a basic standard for evaluating revenue from the sale of “utilitarian” products in relation to the organization’s purposes. If the primary purpose of the product is functional, revenues derived from its sale may be deemed unrelated. As a result, the mailing of a promotion that advertises a product whose primary purpose is functional generally does not qualify for the Nonprofit Standard Mail rates.

Each situation must be considered on a case-by-case basis, including consideration of the product or service advertised and the nature of the authorized organization. An example of an acceptable type of advertisement is one for a blood glucose tester in a publication of an authorized diabetes association.

## C-2 APPLYING IRS RULES TO POSTAL RULES

### C-2.1 Nonprofit or Tax-Exempt Entity

The terms nonprofit and tax-exempt entity include many different organizations. The analysis in this appendix discusses four types of organizations that include many of the organizations affected by the current content-based rules. These four types are the following:

- Churches and other religious organizations.
- Educational institutions.
- Museums.
- Public interest groups.

### C-2.2 Churches and Other Religious Organizations

Postal rules in the context of religious organizations apply principally to the promotion of reading material, to the sale of various other goods, and to church bulletins that contain pages of listings for local businesses and information about church fundraising or other activities.

When the unrelated business income tax was extended to churches, the U.S. Senate Finance Committee stated that unrelated business taxable income would not be generated by the “printing, distribution and sale of religious pamphlets, tracts, calendars, papers, books and magazines with a substantial religious content (even though the document might contain a small amount of advertising), as long as these activities are carried on in connection with the church.” S. Rep. No. 91-552, 91st Cong., 1st Sess. 70 (1969).

Acknowledgments of organizations and individuals who have contributed to the authorized mailer are generally not treated as advertising. Material is considered an acknowledgment, rather than advertising, if it appears on a page under a heading such as “Sponsors,” “Contributors,” or “Donors.” The listings should not be labeled as advertising in other parts of the publication or elsewhere such as rate cards.

For other types of publications marketed by religious organizations, the IRS has stated that an organization must show that the materials are related to some temporary or permanent religious program. Priv. Ltr. Rul. 82-03-005. Examples that the IRS gives include “books on the lives of prominent church leaders or officials; books on family life consistent with church concepts; books on the teachings and/or philosophy of the church.” Priv. Ltr. Rul. 82-03-005. If the publication is nonreligious in nature (for example, a scientific or technical treatise), sales of the publication are usually not considered substantially related to the organization’s religious purposes. Priv. Ltr. Rul. 79-50-029.

Sales of other products by churches and other religious organizations must be substantially related to the organization’s exempt function. The IRS has held that a monastery that raises cattle, grows crops, bakes bread, makes various arts and

crafts, and operates a gift shop must treat as unrelated business income any income earned on the sale of these products through the gift shop or otherwise, except for the clearly religious articles.

Some articles (for example, stained glass artifacts) may have a religious theme and a utilitarian function. These articles are treated as substantially related to the exempt function if designed for and used principally in the exercise of religious activities or beliefs. Priv. Ltr. Ruls. 78-38-029, 78-38-036, 78-38-062.

### C-2.3 Educational Institutions

Educational institutions are involved in many activities that can generate unrelated business taxable income such as:

- Retail sales through bookstores and student stores.
- Publication of reading materials.
- Operation of a hotel or restaurant.
- Public use or lease of its facilities.

Campus bookstores and student stores generally sell a wide range of items that might be needed or desired by students, employees, alumni, and guests. Many items sold have no connection to the educational institution but are sold as a convenience to students and employees. Items that are necessary for a particular class or activity sponsored by the educational institution (for example, textbooks and equipment), items that foster an interest in the institution or provide insight into its purpose (for example, pictures of the institution or its personnel, books, records, cards, and other similar items describing some aspect of the institution) have been found by the IRS to be substantially related.

In the publishing area, under IRS precedent, an educational institution generates tax-exempt income if the books that the institution publishes are scholarly in nature and are published in conjunction with a specific educational program conducted by the institution (for example, a specific department, division, or college in a university). Priv. Ltr. Rul. 82-03-005. Examples of such publications include textbooks, recommended or required course readings, and scholarly works of the faculty, and other writings of the faculty, students, and alumni prepared in conjunction with some course or other activity of the school. Priv. Ltr. Rul. 82-03-005. As a general matter, the Postal Service treats promotional mailings for scholarly publications produced by university presses as substantially related to the university's purposes and, therefore, eligible for the Nonprofit Standard Mail rates.

Colleges and universities also generate income through the public use or lease of their facilities. Generally, the income earned is unrelated business taxable income. For example, although the students' use of a ski facility may be considered substantially related to the school's purposes, fees received from the public are not tax-exempt income because there is no exempt purpose performed by providing use of the facilities to the public, and the facilities are operated in a manner similar to that of commercial facilities. Rev. Rul. 78-98, 1978-1 C.B. 167.

A similar ruling was made in which a college operated a tennis club during the summer. Although the club staff was made up of employees of the school's athletic department, the college was not engaged in activities related to the advancement of education by making the facilities available to the public for a fee. Therefore, the income generated was taxable. Rev. Rul. 80-297, 1980-2 C.B. 196. However, activities offered to the general public (for example, courses, summer camp, conferences) may be considered "substantially related" if the activities are in furtherance of the organization's tax-exempt purpose. Rev. Rul. 77-365, 1977-2 C.B. 192.

#### C-2.4 Museums

Museums primarily generate unrelated business taxable income through the sale of items from their gift shops and catalogs.

Taxable income is not generated by the sale of reproductions of items in the museum's collection or in the collection of a similar museum, or educational materials (including pictures, posters, and postcards) related to or discussing items in the museum. Rev. Rul. 73-104, 1973-1 C.B. 263; Rev. Rul. 73-105, 1073-1 C.B. 264; Priv. Ltr. Ruls. 86-05-002, 81-45-029. Because such items are substantially related to one or more of the museum's purposes, advertisements for them are eligible for mailing at the Nonprofit Standard Mail rates.

Income from the sale of reproductions of items not found in any collection, of items whose utilitarian purpose is not substantially related (that is, the utilitarian purpose of the item dominates its historical or cultural significance), and of general merchandise and typical souvenirs, whether or not they contain a copy of the museum logo, is generally unrelated business taxable income. Rev. Rul. 73-104, 1973-1 C.B. 263; Rev. Rul. 73-105, 1073-1 C.B. 264; Priv. Ltr. Ruls. 86-05-002, 81-45-029.

A museum may not claim exclusion from taxation for items that are unrelated to that particular type of museum, even if the sale of the items generates exempt income if sold elsewhere. For example, an art museum may not sell scientific books and city souvenirs without generating unrelated business taxable income, even though the former may be considered substantially related if sold by a science museum without the income being taxed. Rev. Rul. 74-105, 1973-1 C.B. 264.

The IRS cases dealing with museum gift shops are closely analogous to the issues likely to arise in direct mailings made by museums. The Postal Service will adhere to the IRS classification of museum products.

#### C-2.5 Public Interest Groups

In addition to the three categories previously discussed, many other organizations are tax-exempt entities for income tax purposes and are holders of Nonprofit Standard Mail authorizations. These organizations also participate in a wide range of income-generating activities such as sales of various goods, distribution and sales of Christmas cards, and publication of literature.

As in previous categories, income generated from sales of goods or services is tax exempt if the goods sold or services provided are substantially related to the purposes for which the organization received an exemption. For example, an authorized organization dedicated to promoting and implementing a prominent leader's vision of social, economic, and political justice may sell the following "substantially related" items to the public: books on or about the person; tapes and albums containing his or her speeches and sermons; pictures, posters, and plaques of the person and the organization's buildings; the person's quotations, as well as books, albums, and tapes about the civil rights movement. Rev. Rul. 77-365, 1977-2 C.B. 192. The IRS held that the sale of all these items contributed to the organization's efforts to educate the public about the life and message of its leader.

In the area of services, the operation of a clinic that provides veterinarian care is substantially related to the purposes of an organization that operates for the charitable purpose of preventing cruelty to animals, particularly if the services are provided when the owners of the animals are unable to pay for the services. If the organization uses the information obtained from the clinic to educate the public on how to prevent and treat animal diseases and injuries prevalent in its geographical area, the IRS will consider this activity to be related to the organization's exempt purpose. Such an organization is not able to exempt, however, income from a pet boarding and grooming service because such a commercial service has no causal relationship to the prevention of cruelty to animals. Gen. Couns. Mem. 39,346 (Apr. 30, 1984); Rev. Rul. 73-587, 1973-2 C.B. 192.

Another type of sale or solicitation often used by nonprofit groups is the distribution of greeting cards, particularly Christmas cards, to current and prospective donors with the request for a donation to cover the cost of the cards and the option for the donor to buy additional cards. The mailing of low-cost cards and other products is specifically permitted by the Revenue Forgone Reform Act. However, advertisements for the sale of such cards will generally not be considered to be related to the organization's purposes.