81 T.C. 156 (1983)

Income derived by an exempt civic league from collecting unpaid taxes for its member municipalities, where such activity is substantially related to the league's exempt purpose of promoting effective local government, does not constitute unrelated business taxable income.

Summary

The Kentucky Municipal League (KML), an exempt civic league, contracted with member municipalities to collect their unpaid insurance taxes. KML retained 50% of the collected taxes to cover expenses and as revenue. The IRS determined that KML's share of these taxes was unrelated business taxable income (UBTI). The Tax Court held that KML's tax collection activities were substantially related to its exempt purpose of promoting effective and economical local government, as it provided a valuable service to its members that contributed to their essential governmental functions. Therefore, the income was not UBTI.

Facts

The Kentucky Municipal League is a non-profit organization exempt under section 501(c)(4) as a civic league, promoting effective local government in Kentucky.

Member municipalities authorized KML to collect unpaid insurance taxes, a service some cities found more practical and economical to outsource than to handle internally.

KML contracted with Glenn Lovern & Associates (GLA) for the actual collection work, under KML's supervision.

KML received 50% of the collected taxes, GLA received 37.5%, and the municipalities received the remaining 12.5%.

KML's staff handled administrative tasks related to collections, such as mail, deposits, and inquiries.

The Commissioner determined that KML's share of the collected taxes constituted unrelated business taxable income.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to the Kentucky Municipal League for federal income tax.

The Kentucky Municipal League petitioned the Tax Court for review.

The Tax Court ruled in favor of the Kentucky Municipal League.

© 2025 SCOTUSreports.com. All rights reserved.

Issue(s)

1. Whether the income received by an exempt civic league from collecting unpaid taxes for its member municipalities constitutes income from an unrelated trade or business under Section 512(a)(1) of the Internal Revenue Code.

2. Whether the tax collection activity is substantially related to the Kentucky Municipal League's exempt purpose of promoting social welfare and effective local government.

Holding

1. No, because the income is derived from an activity substantially related to the organization's exempt purpose.

2. Yes, because the tax collection service directly contributes to the essential governmental functions of the member municipalities and promotes effective and economical local government.

Court's Reasoning

The court applied the three-part test for unrelated business taxable income: (1) trade or business, (2) regularly carried on, and (3) not substantially related to the organization's exempt purpose. The court focused on the third prong, substantial relatedness.

The court stated, "Trade or business is 'related' to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (*other than through the production of income*); and it is 'substantially related,' for purposes of section 513, only if the causal relationship is a substantial one. 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."

The court found that KML's exempt purpose was to promote practical, effective, and economical local government. Collecting taxes is an essential function of municipal government. By providing this service, KML relieved municipalities of the burden and expense of tax collection, thus promoting more effective and economical local government.

The court distinguished this case from cases involving business leagues, noting that KML is a civic league assisting exempt organizations (municipalities), whereas business league cases often involve activities that primarily benefit individual members' businesses, not the broader exempt purpose.

© 2025 SCOTUSreports.com. All rights reserved.

The court also addressed the Commissioner's argument that KML's activities were similar to a commercial collection agency. While acknowledging commercial agencies exist, the court found KML provided a unique service by coordinating collections for multiple cities and maintaining oversight and control in a way that individual cities might not entrust to a commercial agency. This unique aspect further supported the substantial relatedness to KML's exempt purpose.

Practical Implications

This case clarifies that services provided by exempt organizations to their members can be considered substantially related to their exempt purpose, even if those services generate income.

It emphasizes that the critical factor is whether the service contributes importantly to the organization's exempt purpose, not merely whether it generates funds or resembles a commercial activity.

For civic leagues and similar exempt organizations, this case provides support for offering services to member entities that directly aid in their governmental or charitable functions without necessarily creating unrelated business income.

Later cases would likely distinguish this ruling based on the specific nature of the exempt organization, the services provided, and the directness of the contribution to the exempt purpose. Organizations need to demonstrate a clear and substantial causal link between their income-generating activities and their exempt functions to rely on this precedent.

© 2025 SCOTUSreports.com. All rights reserved.