Kentucky Municipal League v. Commissioner, 81 T. C. 88 (1983)

Income from services provided by a tax-exempt organization is not unrelated business taxable income if it is substantially related to the organization's exempt purposes.

Summary

The Kentucky Municipal League (KML), a non-profit civic league, assisted its member cities in collecting unpaid taxes from insurance companies. The IRS determined that KML's share of the collected taxes constituted unrelated business taxable income. The Tax Court held that KML's collection activities were substantially related to its exempt purpose of promoting practical and effective local government, thus the income was not taxable. The court emphasized that KML's services directly contributed to the cities' essential functions, distinguishing it from commercial collection activities.

Facts

The Kentucky Municipal League (KML) is a non-profit organization exempt under section 501(c)(4) as a civic league promoting social welfare. KML's primary function is to assist Kentucky cities in practical, effective, and economical local government. Since 1954, KML has helped approximately 70 of its 150 member cities collect unpaid license taxes from insurance companies. KML entered into contracts with these cities, assuming all collection expenses in exchange for 50% of the collected taxes. In 1977, KML received $219,325. 73 from these collections, retaining $29,799 after payments to the cities and to Glenn Lovern & Associates (GLA), who performed the actual collection work under KML's supervision.

Procedural History

The IRS determined a deficiency of $4,373 in KML's federal income tax for the fiscal year ending June 30, 1977, asserting that KML's share of the collected taxes was unrelated business taxable income. KML petitioned the Tax Court for a redetermination of this deficiency. The Tax Court, after reviewing the stipulated facts, held that KML's collection activities were substantially related to its exempt purposes and thus not subject to tax.

Issue(s)

1. Whether the income derived by KML from its tax collection activities constitutes unrelated business taxable income under section 512(a)(1) of the Internal Revenue Code.

Holding

1. No, because the court found that KML's tax collection activities were substantially

© 2025 SCOTUSreports.com. All rights reserved.

related to its exempt purposes of promoting practical and effective local government.

Court's Reasoning

The court applied the three-part test from section 1. 513-1(a) of the Income Tax Regulations to determine if income is unrelated business taxable income: (1) whether the activity is a trade or business, (2) whether it is regularly carried on, and (3) whether it is substantially related to the organization's exempt purposes. The court focused on the third element, finding that KML's collection activities were substantially related to its exempt function of promoting effective local government. The court reasoned that KML's assistance in collecting taxes was an essential service that directly contributed to the cities' ability to perform their governmental functions, as stated in the opinion: "The collection of the taxes is certainly an essential function of the city, and when the league performed that function for the city, it was carrying out the very purpose for its organization and operation. " The court distinguished KML's activities from those of commercial collection agencies, noting that KML's oversight and authority over the collection process were services that the cities might not have been willing to delegate to a commercial entity. The court rejected the IRS's reliance on cases involving business leagues, emphasizing that KML, as a civic league, was assisting governmental entities in their exempt activities.

Practical Implications

This decision clarifies that income from services provided by a tax-exempt organization can be exempt from unrelated business income tax if those services are substantially related to the organization's exempt purposes. Legal practitioners advising non-profit organizations should carefully analyze the relationship between the organization's income-generating activities and its exempt functions. This case suggests that services directly supporting the essential functions of member organizations, especially governmental entities, are likely to be considered substantially related. The ruling may encourage non-profits to engage in activities that directly support their members' core functions without fear of incurring unrelated business income tax. Subsequent cases, such as Hi-Plains Hospital v. United States, have applied similar reasoning to determine the tax-exempt status of income from services provided by non-profit organizations.

© 2025 SCOTUSreports.com. All rights reserved.