Fraternal Order of Police Illinois State Troopers Lodge No. 41 v. Commissioner of Internal Revenue, 87 T.C. 747 (1986)

Advertising revenue generated by an exempt organization's publication can constitute unrelated business taxable income if the advertising activity is considered a trade or business, regularly carried on, and not substantially related to the organization's exempt purpose.

Summary

The Fraternal Order of Police (FOP), an exempt organization, published a magazine called "The Trooper" which contained articles relevant to police officers and business listings. The listings were of two types: a business directory and larger display ads. The IRS determined that income from these listings was unrelated business taxable income. The Tax Court held that the business listings constituted advertising, the publication of which is a trade or business. Because this business was regularly carried on and not substantially related to FOP's exempt purpose, the income was taxable. The court also rejected FOP's argument that the income was excludable as royalties.

Facts

The Fraternal Order of Police (FOP) Illinois State Troopers Lodge No. 41 was a tax-exempt organization under section 501(c)(8) of the Internal Revenue Code. FOP published "The Trooper" magazine, which included articles for police officers and two types of business listings: a classified business directory and larger display advertisements. Organization Services Corp. (OSC) solicited and managed the listings under agreements with FOP, and FOP received a percentage of the gross advertising revenue. The listings covered a wide range of goods and services and were marketed to businesses as a way to support FOP and its charitable activities. Acknowledgement forms and checks from businesses often referred to payments as "advertising.".

Procedural History

The Commissioner of the Internal Revenue determined deficiencies in FOP's income tax, asserting that receipts from the business listings in "The Trooper" constituted unrelated business taxable income. FOP challenged this determination in the United States Tax Court.

Issue(s)

1. Whether the publication of business listings in "The Trooper" magazine constitutes a "trade or business" within the meaning of section 513 of the Internal Revenue Code.
2. If the publication of business listings is a trade or business, whether the income derived from these listings is excludable from unrelated business

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taxable income as royalties under section 512(b)(2) of the Internal Revenue Code.

Holding

1. Yes, the publication of business listings in "The Trooper" constitutes a "trade or business" because it is an activity carried on for the production of income from the sale of services (advertising), as unambiguously established by Congress in section 513(c).
2. No, the income derived from the business listings is not excludable as royalties because FOP's involvement in the publication was active, not passive, and the payments were for advertising services, not for the use of FOP's name in a passive royalty arrangement.

Court's Reasoning

The court reasoned that section 513(c) of the Internal Revenue Code explicitly defines "trade or business" to include "any activity which is carried on for the production of income from the sale of goods or the performance of services," and further clarifies that "advertising income from publications…will constitute unrelated business income." The court found that the listings in "The Trooper" were indeed advertising, resembling listings in commercial publications and telephone directories, and marketed as such. The court cited *United States v. American College of Physicians*, stating, "The statute clearly established advertising as a trade or business…because Congress has declared unambiguously that the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational articles and editorial content." The court also noted FOP's profit motive and active role in the publication through agreements with OSC, content control, and financial oversight. Regarding the royalty exclusion, the court determined that royalties are typically passive income for the use of rights like trademarks. However, FOP's active involvement in the magazine's publication, including content control and oversight of the advertising program, indicated that the income was not passive royalties but rather payment for services rendered in a trade or business.

Practical Implications

This case clarifies that income from advertising in publications of tax-exempt organizations is generally considered unrelated business taxable income (UBTI). It emphasizes that Congress has explicitly defined advertising as a trade or business for UBTI purposes. Exempt organizations must carefully evaluate revenue from advertising activities in their publications. The case highlights that even if a publication serves an exempt purpose through its editorial content, advertising revenue within it can still be taxable. Furthermore, the decision reinforces the distinction between active business income and passive royalty income, particularly in the context of exempt organizations. Organizations cannot easily recharacterize

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active income streams, like advertising sales where they retain control and involvement, as passive royalties to avoid UBTI. This case, along with *American College of Physicians*, serves as a key precedent in determining UBTI for exempt organizations engaged in publishing activities with advertising components.

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