National Water Well Association, Inc. v. Commissioner, 92 T. C. 75 (1989)

Dividends received by a tax-exempt business league from an insurance program it endorsed and actively managed are taxable as unrelated business income when the activity constitutes a trade or business not substantially related to the organization's exempt purpose.

Summary

In National Water Well Association, Inc. v. Commissioner, the Tax Court ruled that dividends received by a business league from an insurance program it endorsed were taxable as unrelated business income. The Association, exempt under section 501(c)(6), received a significant dividend from an industry casualty insurance program it actively promoted and administered. The court determined that the Association's activities constituted a trade or business due to its profit motive and extensive involvement, and the income was unrelated to its exempt purpose because it did not benefit the industry as a whole but rather individual members. The decision underscores the importance of ensuring that income-generating activities of exempt organizations are closely aligned with their tax-exempt purposes to avoid taxation.

Facts

The National Water Well Association, Inc. , a business league exempt from taxation under section 501(c)(6), endorsed and sponsored an industry casualty insurance program developed by Maryland Casualty Insurance Co. The Association agreed to provide marketing and administrative services, including providing membership lists, writing safety articles, offering exhibit space at conventions, and distributing information about the insurance. In 1980, the Association received a dividend of $271,293 from Maryland Casualty, retaining $117,188 after distributing the remainder to insured members. The Association used a portion of the retained dividend to promote safety in the industry.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Association's Federal income tax, asserting that the retained dividend was unrelated business taxable income (UBTI). The Association contested this determination, arguing that the dividend was either not derived from a trade or business or was substantially related to its exempt purpose. The case was submitted fully stipulated to the United States Tax Court, which issued its opinion in 1989.

Issue(s)

1. Whether the dividends received by the Association from the industry casualty insurance program constitute unrelated business taxable income under section 512?
2. If so, whether the income is excludable from the unrelated business tax as

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royalties under section 512(b)(2)?

Holding

1. Yes, because the Association's activities in endorsing and managing the insurance program constituted a trade or business carried on with a profit motive, and the income was not substantially related to the Association's exempt purpose.
2. No, because the dividends were not passive income but compensation for the Association's active involvement in the insurance program.

Court's Reasoning

The court applied the profit motive test to determine that the Association's activities constituted a trade or business. The Association's extensive involvement in promoting and administering the insurance program, coupled with the significant dividends it received, indicated a profit motive. The court cited Professional Insurance Agents of Michigan v. Commissioner and other cases to support its conclusion that the activities were conducted in a competitive, commercial manner.

The court also found that the income was not substantially related to the Association's exempt purpose of promoting the water well industry. The benefits of the insurance program were limited to individual members who paid premiums, rather than benefiting the industry as a whole. The court emphasized that the Association's conduct of the activity did not contribute importantly to its exempt purposes, as required by the regulations.

The court rejected the Association's argument that the dividends were royalties, noting that the income was not passive but compensation for the Association's active role in the insurance program.

Practical Implications

This decision underscores the importance of ensuring that income-generating activities of tax-exempt organizations are closely aligned with their exempt purposes. Organizations endorsing or managing insurance programs should carefully consider whether their involvement constitutes a trade or business and whether the income benefits the industry as a whole or only individual members.

Exempt organizations must be cautious in structuring their activities to avoid generating unrelated business income, which could subject them to taxation. The decision also highlights the need for organizations to maintain a clear separation between their exempt activities and any commercial endeavors.

Later cases, such as Fraternal Order of Police Illinois State Troopers Lodge No. 41 v. Commissioner, have applied similar reasoning to determine whether an organization's activities constitute a trade or business and whether the income is substantially related to its exempt purpose.

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