Ohio Farm Bureau Federation, Inc. v. Commissioner of Internal Revenue, 106 T. C. 222 (1996)

Payments received by a tax-exempt organization for services related to its exempt purpose and for noncompetition are not unrelated business income if they do not arise from a regularly conducted trade or business.

Summary

The Ohio Farm Bureau Federation, a tax-exempt agricultural organization, received payments from Landmark, Inc. , under a service contract to promote agricultural cooperatives and from a noncompetition clause upon the termination of their relationship. The Tax Court held that the service contract payments were substantially related to the Federation's exempt purpose and thus not unrelated business taxable income (UBTI). Additionally, the noncompetition payment was not UBTI because it did not stem from a trade or business regularly carried on by the Federation. The court's decision hinged on the activities' alignment with the organization's exempt purposes and the non-regular nature of the noncompetition agreement.

Facts

The Ohio Farm Bureau Federation, a tax-exempt organization under section 501(c)(5), formed Landmark, Inc. , in 1934 to promote agricultural cooperatives. In 1949, they entered a service contract where the Federation agreed to perform promotional and educational services for Landmark in exchange for fees. This relationship continued until 1985 when Landmark merged with another cooperative, leading to the termination of their contract. The termination agreement included a noncompetition clause, for which the Federation received $2,064,500. The Commissioner of Internal Revenue challenged the tax-exempt status of these payments as UBTI.

Procedural History

The Commissioner determined deficiencies in the Federation's federal income tax for the taxable periods ending August 31, 1985, and August 31, 1986. The Federation petitioned the U. S. Tax Court to challenge these deficiencies, specifically contesting whether the payments under the service contract and the noncompetition clause constituted UBTI.

Issue(s)

1. Whether the $292,617 received by the Federation under the service contract with Landmark during the taxable year ending August 31, 1985, constituted unrelated business taxable income.
2. Whether the lump-sum payment of $2,064,500 made by Landmark to the Federation pursuant to a noncompetition clause constituted unrelated business

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taxable income.

Holding

1. No, because the services provided by the Federation were substantially related to its tax-exempt purpose of promoting agricultural cooperatives.
2. No, because the noncompetition payment did not arise from a trade or business regularly carried on by the Federation.

Court’s Reasoning

The court found that the Federation’s activities under the service contract were unique to its exempt purpose and benefited its members as a group, not individually, thus not constituting UBTI. The court applied the three elements for UBTI: the activity must be a trade or business, regularly carried on, and not substantially related to the organization’s exempt purpose. For the noncompetition payment, the court ruled it was not derived from a trade or business since it was a one-time event, lacking the continuity and regularity required for UBTI. The court cited *Commissioner v. Groetzinger* and other cases to distinguish sporadic activities from those regularly conducted as a business. The decision was influenced by the policy against taxing income that does not compete with taxable businesses.

Practical Implications

This ruling clarifies that payments for services aligned with an exempt organization’s purpose are not taxable as UBTI, provided they are not conducted as a regular business activity. It also establishes that noncompetition payments, if not part of regular business activity, are similarly exempt. Legal practitioners advising tax-exempt organizations should ensure that service contracts and termination agreements are structured to support the organization’s exempt purpose and avoid activities that could be construed as regularly conducted business. This case has been influential in subsequent cases involving similar tax issues for exempt organizations and has implications for how these organizations structure their relationships with for-profit entities to maintain their tax-exempt status.

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