

LEGAL

Is your publication's ad revenue taxable?

By Jonathan May

Publications that generate “circulation income,” such as subscription payments, and net income from advertisements can be an important source of revenue for a tax-exempt organization. Revenues from circulation income generally are not subject to federal income tax, but net advertising income generally is taxable as unrelated business income.

However, when the costs of publishing exceed the amount of circulation income generated, exempt organizations can take advantage of a special exception to the rule, which excludes from taxation the amount of net advertising income equal to the amount of publishing costs that exceed circulation income.

A specific aspect of this rule was considered in a recent U.S. Tax Court decision, *National Education Association of the United States v. Commissioner of Internal Revenue*. NEA is exempt from tax under IRC Section 501(c)(5). In the case before the court, NEA had not reported net advertising income from its publication as taxable because publishing costs far exceeded circulation income. The IRS asserted that NEA had essentially underreported its circula-

tion income because members did not pay a subscription fee, and no part of their membership dues were allocated as payment for the publications they received from NEA.

At issue in the case was how the wording of a Treasury regulation should be interpreted. The regulation provides, in short, that when members have the “right to receive” an exempt organization’s publications and don’t pay for the subscriptions, a portion of their membership dues must be allocated to circulation income for purposes of determining whether net advertising income is taxable.

The initial question the court wrestled with was the meaning of the phrase “right to receive.” NEA argued that for the regulation to apply, the right must be legally enforceable, whereas the government took the position that something less than a legal right will suffice. The NEA won the battle on this point, but it would ultimately lose the war based on the facts of the case.

The court next embarked on a review of NEA operations and documents to determine whether its members had a legal right to receive its publications. The court noted that NEA’s bylaws explicitly stated

that members were eligible to receive its publications and pointed out that membership enrollment forms, handbooks, and the publications’ mastheads described the publications as member benefits. The court believed that other factors demonstrated that NEA had a practical obligation to continue publishing its periodicals, including that the publication schedule was set a year in advance and that contracts with advertisers required NEA to maintain a certain level of circulation.

Considering all these factors, the court determined that NEA’s members did have the right to receive its publications. This finding required NEA to allocate a portion of membership dues to circulation income—and this meant that NEA was required to pay taxes on its net advertising income.

The case is not likely to be the final word on this issue, but it provides instructive guidance that exempt organizations should consider. An association that has a publication with paid advertising but neither charges its members for subscriptions nor allocates a portion of membership dues to circulation income should determine whether its members have the right to receive the publication. In addition to the items described above, several other factors should be considered, including:

- membership materials (applications and agreements, benefits policies, dues statements, and agreements with affiliates and chapters)
- corporate documents (charter, constitution, and bylaws)
- marketing materials
- availability of the publication to subscribers and nonsubscribers in print and online

If the analysis indicates an association’s members do not have the right to receive the publication, then the association’s related net advertising income may not be taxable. But if an association determines that its members do have this right, it may be required to report and pay tax on some or all of its net advertising income.

Jonathan May practices law with Whiteford, Taylor & Preston LLP in Columbia, Maryland. Email: jmay@wtplaw.com. He acknowledges Megan Spratt's contribution to this article.