

P. RECENT DEVELOPMENTS UNDER THE UNRELATED TRADE OR BUSINESS PROVISIONS

1. Introduction

This is an update of Topic S in the 1979 EOATRI Textbook. Items noted in the 1979 EOATRI Textbook are not repeated here, unless there have been changes in the status of these items.

2. Administrative Developments

a. P.L. 95-502, 1978-2 C.B. 393, amended IRC 513 (adding IRC 513(f)) to provide that the income from the conduct of certain bingo games, operated in accordance with state and local laws and not in competition with profit-making businesses, is not subject to tax. Proposed regulations under IRC 513(f) were published in the Federal Register on August 28, 1979, and a copy of these proposed regulations follows the text as Attachment 1.

b. P.L. 94-396, 1976-2 C.B. 531, amended IRC 512(b)(5) to provide that gain from the lapse or termination of options occurring after December 31, 1975, will not constitute unrelated business taxable income if the gain is in connection with the investment activities of exempt organizations (other than organizations described in IRC 501(c)(7) or 501(c)(9)). Proposed regulations under IRC 512(b)(5) were published in the Federal Register on November 29, 1978, and final regulations with minor clarifying revisions were published in the Federal Register on July 20, 1979. A copy of the final regulations follows the text as Attachment 2.

3. IRC 512 Developments

a. Rev. Rul. 79-222, 1979-30 I.R.B. 6, holds that the investment of an exempt employees' trust as a limited partner in a partnership carrying on an unrelated trade or business may result in unrelated business taxable income within the meaning of IRC 512.

b. New Issues Considered

(1) Whether income derived by an exempt organization from an arm's length transaction with a commercial publisher to publish a trade journal for the exempt organization's members is royalty income

under IRC 512(b)(2). The contract provided, in part, that the publisher was to bear all costs of gathering material, design, photography, printing, and mailing to the exempt organization's members. The publisher was to confine the content of the periodical to serve the exempt organization's stated purposes and was required to pay the exempt organization a percentage of the gross advertising billings, but only after these advertising billings reached a stated amount.

(2) We are still considering the issue of whether receipts from licenses permitting the use of an exempt organization's name in commercial contexts constitute income from an unrelated trade or business under IRC 513, and if so, whether such amounts are royalties under IRC 512(b)(2).

c. Pro Rata Allocation of Membership Receipts

In the 1979 EOATRI Text, Topic W concerning the Advertising Regulations (page 536), discussed a problem that has arisen in the interpretation of Reg. 1.512(a)-1(f)(4)(iii), pro rata allocation of membership receipts. Under Reg. 1.512(a)-1(f)(3), it is necessary to allocate membership dues to circulation income in determining the unrelated business taxable income from the sale of advertising. This is necessary since in most cases the UBTI is computed by allowing a deduction (the excess of periodical costs over circulation income) against excess advertising income. Under the regulations three methods are given for allocating membership dues to circulation income. Under the third method, a formula is given and the question is whether the term "other exempt activity costs" means gross or net costs. In other words, should the income produced by exempt activities be required to reduce the costs from such activities in using this formula. An example will illustrate the problem:

Two organizations (A & B) both publish a related magazine. They both have the following income and costs:

Advertising Income	\$ 200
Membership dues	1000
Periodical Costs	700
Other Exempt Activity Costs	300

In addition to the above, organization B also conducts a related trade show which costs \$9,000. This amount is recovered through the rental of space at the

show and through admission charges. If gross expenses are used, organization A will allocate \$700 ($\$1,000 \times 700/10,000$) of dues to the publication and organization B will allocate \$70 ($\$1,000 \times 700/10,000$). The Service has been using net cost on the assumption that there is no reason to allocate dues or other exempt activities to the extent these activities are self-supporting. However, there is support for the gross cost approach because the language of Reg. 1.512(a)-1(f)(4)(iii), "cost of other exempt activities", may be interpreted to simply mean total costs or expenses incurred by an organization in connection with its other exempt activities. The National Office has considered this issue and has decided to adopt the gross cost approach.

4. IRC 513 Developments

a. Rev. Rul. 79-31, 1979-1 C.B. 206, holds that the operation of a fringe parking lot and a shuttle bus service by an organization exempt under IRC 501(c)(6) whose primary purpose is to retain and stimulate trade in a city's downtown area is not an unrelated trade or business within the meaning of IRC 513. However, the organization's operation of a park and shop plan in which patrons of particular member merchants receive stamps entitling them to free parking is an unrelated trade or business.

b. Rev. Rul. 79-360, 1975-45 I.R.B. 11, holds that the operation of health club facilities in a commercial manner by an organization exempt under IRC 501(c)(3) whose purpose is to provide for the welfare of young people, constitutes unrelated trade or business under IRC 513.

c. Rev. Rul. 79-361, 1975-45 I.R.B. 11, holds that the operation of a miniature golf course in a commercial manner by an organization exempt under IRC 501(c)(3), whose purpose is to provide for the welfare of young people, constitutes unrelated trade or business under IRC 513.

d. New Issues Considered

(1) Whether the production and sale of certain religious and non-religious items is substantially related to the exempt purposes of a monastery under IRC 513(a), and whether the work that is performed for the monastery is "without compensation" under IRC 513(a)(1) where the members of the monastery do not receive salary or wages or other direct compensation, but receive food, clothing, shelter, medical care, etc., from the monastery and it is the income that is produced as

a result of their work that makes it possible for the monastery to provide for their support.

(2) Whether the operation of a woodworking industry in connection with a church-related high school constitutes an unrelated trade or business under IRC 513 where the woodworking business is used to provide students with direct training in woodworking skills, to assume responsibility, and to learn to work efficiently.

(3) Whether the sale of limited edition art reproductions by an educational organization which does not own or operate a museum nor has a collection of art objects available for public viewing constitutes income from an unrelated trade or business under IRC 513.

(4) Whether the operation of travel tours arranged by an IRC 501(c)(5) organization of educators is related to its exempt purposes under IRC 513 where the tours include substantial participation in self improvement or skill improvement programs. (See 1979 EOATRI, Topic T, page 453.)

(5) Whether the operation of a dining facility, restricted to the members of an exempt IRC 501(c)(3) educational organization, is substantially related to the organization's exempt purposes under IRC 513.

(6) Whether a hospital, exempt under IRC 501(c)(3), is engaged in an unrelated business under IRC 513 by treating patients from other hospitals because of its specialized facilities for the treatment of certain medical conditions.

(7) Whether the certification of export documents by a chamber of commerce exempt under IRC 501(c)(6) is an unrelated trade or business under IRC 513.

(8) Whether the operation of a translation service by a trade association exempt under IRC 501(c)(6) constitutes an unrelated trade or business under IRC 513.

(9) Whether the Service will follow the decision in the case of Oklahoma Cattlemen's Association v. United States, 310 F. Supp. 320

(W.D. Okla. 1969), which held that an insurance program operated by an organization exempt under IRC 501(c)(5) for its members does not constitute the conduct of an unrelated trade or business under IRC 513.

e. Judicial Decisions

(1) Independent Insurance Agents of Northern Nevada, Inc. v. U.S., 79-2 U.S.T.C. 9601, U.S. Dist. Ct., Nev., 8-27-79. An organization whose primary purpose is to serve the insurance needs of tax supported public agencies was recognized as exempt under IRC 501(c)(6). In addition to seminars and educational activities for the state insurance industry, it counseled tax supported local governmental agencies with regard to insurance programs and serviced insurance written for such agencies for the purpose of removing the placement of this business from political favoritism or influence and for providing suitable coverage at the lowest possible cost to the taxpayer. In consideration for acting as insurance broker for the governmental agencies the organization was paid a brokerage commission. The Service determined that this income, less proper expenses, realized from its activities as an insurance supplier was taxable as unrelated business income. The Court, in this refund action, held that the service of managing the insurance needs of tax supported public agencies was an exempt purpose qualifying the organization as a business league under IRC 501(c)(6) and was not subject to tax as unrelated business income.

(2) Carle Foundation v. U.S., 79-2 U.S.T.C. 9727, 7th Circuit, No. 79-1273, 11-29-79. A hospital with a self-contained pharmacy, exempt under IRC 501(c)(3), rented out office space within its complex to a non-exempt private clinic operated for profit by the same doctors who comprise the medical staff of the hospital. The hospital and clinic share some physical facilities, equipment, and services and clinic patients requiring hospitalization are admitted to the hospital. However, the hospital and clinic are distinct entities. The hospital pharmacy supplies pharmaceuticals to the hospital, the hospital's employees, the clinic, clinic employees, and some of the clinic's private patients. Sales to hospital employees did not constitute unrelated business income because they were carried on primarily for the convenience of the employees under IRC 513(a)(2), and in an addendum it was brought to the lower court's attention that the government did not contest sales to the hospital employees. However, the sale of pharmaceuticals by the hospital pharmacy to the clinic, clinic employees, and to the clinic's private patients gave rise to unrelated business income under IRC 513. The lower court had considered clinic patients to be patients of the hospital and thus excluded this

income as being primarily for the convenience of the hospital's "patients" under IRC 513(a)(2). The Court of Appeals stated that clinic patients could not be transformed into hospital patients simply because the hospital did some testing of clinic patients. In addition, the Court of Appeals held that pharmaceutical sales to clinic patients and the clinic were not substantially related to the exempt purposes of the hospital (See 1979 EOATRI for discussion of lower court decision on page 446).

5. IRC 514 Developments

a. Rev. Rul. 79-122, 1979-1 C.B. 204, holds that employer securities purchased with borrowed funds by a qualified trust forming part of a leveraged employee stock ownership plan that satisfies the requirements of IRC 4975(e)(7) are not debt-financed property within the meaning of IRC 514(b), and dividends and interest earned on such securities are not unrelated business taxable income to the trust. Rev. Ruls. 71-311, 1971-2 C.B. 184, and 74-197, 1974-1 C.B. 143, distinguished.

b. New Issues Considered

(1) Whether property leased to an industrial tenant by an organization exempt under IRC 501(c)(6) constitutes debt-financed property within the meaning of IRC 514(b)(1). The organization's primary purpose is to encourage new industries to move to their geographical area. As part of this program, the organization constructed a shell building on land donated to it by a city. The construction of the building was financed by contributions from the members of the organization.

The organization's intention was to attract a new industry to their community by offering to lease the building at a favorable rent. The organization entered into a lease agreement with a tenant, and the building was completed to suit the needs of the tenant. The completion of the building was financed by subjecting the property to a mortgage.

(2) Whether the stock acquired by an IRC 501(c)(3) organization from its wholly-owned nonexempt subsidiary will be debt-financed, within the meaning of IRC 514(b)(1), should the exempt organization promise the subsidiary's lending institution that it

will purchase in the future the mortgage note created between the subsidiary and the lending institution.

c. Articles

(1) "Rulings Holding Insurance Plans of Exempt Organizations Taxable May Threaten Exemptions", by Joseph Grief and Robert L. Goldstein, Journal of Taxation, May 1979, page 294. Authors analyze recent ruling letters issued concerning group insurance activities of IRC 501(c)(6) organizations.

(2) "What the CPA Should Know About Church Tax Changes", by David E. Crawford, Journal of Accountancy, June 1979, page 80. Author analyzes the application of the unrelated business income tax to churches.

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR Part 1]

[CC:EE-180-78]

Income tax; Treatment of Proceeds From Bingo Games

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the treatment of proceeds from bingo games. Changes to the applicable tax law were made by the Act of October 21, 1978. The regulations would provide the public with the guidance needed to comply with that Act and would affect exempt organizations and political organizations that conduct bingo games.

DATES: Written comments and requests for a public hearing must be delivered or mailed by October 29, 1979. The amendments are proposed to be effective for exempt organizations for taxable years beginning after December 31, 1969, and for political organizations for taxable years beginning after December 31, 1974.

ADDRESS: Send comments and request for a public hearing to: Commissioner of Internal Revenue, Attention: CC:LR:T:EE-180-78, Washington, D.C. 20224.

FOR FURTHER INFORMATION CONTACT: Charles Kerby of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224, Attention: CC:LR:T:EE-180-78, 202-566-3422, (Not a toll-free call).

SUPPLEMENTARY INFORMATION:

BACKGROUND

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under sections 513 and 527 of the Internal Revenue Code of 1954, as amended by sections 301 and 302 of the Act of October 21, 1978 (P.L. 95-502; 92 Stat. 1702). The amendments are to be issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

Exempt Organizations

A tax exempt organization is generally taxed on the income received from any "unrelated trade or business" conducted by the organization. Under prior law, a bingo game conducted by an exempt organization generally constituted an unrelated trade or business. Under Pub. L. 95-502, the term "unrelated trade or business" does not include the conducting of bingo games.

Political Organizations

A political organization is taxed on the income it receives that is not "exempt function income." Under prior law, proceeds from bingo games were not exempt function income and were, therefore, included in the taxable income of a political organization. Pub. L. 95-502 redefines the term "exempt function income" to include proceeds from bingo games.

Comments and Requests for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably six copies) to the Commissioner of Internal Revenue. All comments will be available for public inspection and copying.

A public hearing will be held upon written request to the Commissioner by any person who has submitted written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations was Charles Kerby of the Employee Plans and Exempt Organizations Division of the Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style.

Proposed Amendments to the Regulations

The proposed amendments to 26 CFR Part 1 are as follows:

Paragraph 1. There is added in the appropriate place the following new section:

Section 1.513-5 Certain bingo games not unrelated trade or business.

(a) *In general.* Under section 513(f), and subject to the limitations in paragraph (c) of this section, in the case of an organization subject to the tax imposed by section 511, the term "unrelated trade or business" does not include any trade or business that consists of conducting bingo games (as defined in paragraph (d) of this section).

(b) *Exception.* The provisions of this section shall not apply with respect to any bingo game otherwise excluded from the term "unrelated trade or business" by reason of section 513(a)(1) and Section 1.513-1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) *Limitations--(1) Bingo games must be legal.* Paragraph (a) of this section shall not apply with respect to any bingo game conducted in violation of State or local law.

(2) *No commercial competition.* Paragraph (a) of this section shall not apply with respect to any bingo game conducted in a jurisdiction in which bingo games are ordinarily carried out on a commercial basis. Bingo games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried

on (within the meaning of Section 1.513-1(c)) by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if State law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis.

(3) *Examples.* The application of this paragraph is illustrated by the following examples:

Example (1). (i) Rescue Squad X ("X") a tax-exempt organization, conducts weekly bingo games in State M. The bingo games are operated by individuals who are compensated by X for their services and are, therefore, not excluded from the term "unrelated trade or business" under section 513(a)(1). (ii) State M has a statutory provision that prohibits all forms of gambling including bingo games. However, that law is not enforced by State officials against local charitable organizations such as X that conduct bingo games to raise funds. Since bingo games are illegal under State law, X's bingo games constitute unrelated trade or business regardless of whether, or to what degree, the State law is enforced.

Example (2). (i) Veterans' organizations Y ("Y") and X ("X"), both tax-exempt organizations, conduct weekly bingo games in State N. The bingo games are operated by individuals who are compensated for their services by Y and X and are, therefore, not excluded from the term "unrelated trade or business" under section 513(a)(1).

(ii) State N has a statutory provision that permits bingo games to be conducted by tax-exempt organizations. In addition, State N permits bingo games to be conducted by for-profit organizations in city S, a resort community located in county R. Several for-profit organizations conduct nightly bingo games in city S. Y conducts its weekly bingo games in city S. X conducts its weekly bingo games in county R outside of city S. Since State law confines the conduct of bingo games by for-profit organizations to city S, and since bingo games are regularly carried on there by those organizations. Y's bingo games conducted in city S constitute unrelated trade or business.

However, X's bingo games conducted in county R outside of city S do not constitute unrelated trade or business.

(d) *Bingo game defined.* A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term "bingo game" means any game of bingo of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term "bingo game" does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

(e) *Effective date.* Section 513(f) and this section apply to taxable years beginning after December 31, 1969.

Par. 2. Section 1.527-3(b)(1) is revised to read as follows:

Section 1.527-3 Political organization taxable income.

* * * * *

(b) *Exempt function income defined--(1) In general.* For purposes of section 527 and these regulations the term "exempt function income" means any amount received as--

(i) A contribution of money or other property;

(ii) Membership dues, fees, or assessments from a member of a political organization;

(iii) Proceeds from a political fund raising or entertainment event, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business; and

(iv) Proceeds from the conduct of any bingo game (as defined in section 513 (f)(2)) unless the proceeds were held on October 21, 1978, by the political organization that conducted the bingo game and thereafter were used by that organization to make

a contribution or expenditure (as defined in section 301 (e) and (f) of the Federal Election Campaign Act of 1971; 2 U.S.C. 431 (e), (f)) in connection with an election held before January 1, 1979, to the extent such amount is segregated for use only for the exempt function of the political organization. (See also Section 1.527-4 regarding the treatment of expenditures for a judicially determined illegal activity.)

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Jerome Kurtz,
Commissioner of Internal Revenue.

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 7632; EE-172-78]

Tax Treatment of Certain Option Income of Exempt Organizations

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final regulations relating to the tax treatment of certain option income of exempt organizations. Changes to the applicable tax law were made by the Act of September 3, 1976. The regulations apply to most, but not all, exempt organizations. They provide exempt organizations with guidance needed to determine their unrelated business taxable income.

DATE: The amendments are effective for options which lapse or terminate on or after January 1, 1976.

FOR FURTHER INFORMATION CONTACT:

Margie Glass of the Employee Plans and Exempt Organizations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224 (Attention: CC:LR:T) (202-566-3544) (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

On November 29, 1978, proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 512(b) of the Internal Revenue Code of 1954 were published in the Federal Register (43 FR 55796). The amendments were proposed to conform the regulations to section 1 of the Act of September 3, 1976 (90 Stat. 1201) and sections 1901(b)(8)(F) and 1951(b)(8)(A) of the Tax Reform Act of 1976 (90 Stat. 1794, 1839). No comments were received and no public hearing was requested or held. The Treasury decision adopts the proposed amendments with minor clarifying revisions.

Explanation of Regulations

The amendment to section 512(b)(5) provides that gain from the lapse or termination of options occurring after December 31, 1975, will not constitute unrelated business taxable income to exempt organizations if it is in connection with the investment activities of such organizations. However, the amendment does not apply to organizations described in sections 501(c)(7) or 501(c)(9), or certain organizations described in section 501(c)(2). The amendment conforms the regulations to the amendments to section 512(b)(5) and defines what is meant by termination of an option. The amendment also conforms the regulations to reflect changes made to section 512(b) by the Tax Reform Act of 1976.

Drafting Information

The principal author of these regulations is Margie Glass of the Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulation, both on matters of substance and style. Adoption of amendments to the Regulations

Accordingly, the proposed amendments to 26 CFR Part [ILLEGIBLE] are adopted, except that paragraph (d)(2) of Section 1.512(b)-1, as set forth in paragraph 3 of the notice of proposed rulemaking, is changed.

Section 1.511 [Deleted]

Paragraph 1. Section 1.511 is deleted.

Section 1.511-2 [Amended]

Par. 1A. Paragraph (a)(3)(iii) of Section 1.511-2 is amended by deleting "section 512 (b)(16)", and inserting in lieu thereof "section 512(b)(14)".

Section 1.512 [Amended]

Par. 2. Section 1.512(b) is deleted.

Par. 3. Section 1.512(b)-1 is amended as follows:

1. Paragraph "(d)" is redesignated "(d)(1)" and paragraph (d)(2) is added as set forth below.

2. Paragraph (j)(1) is amended by deleting "educational institution (as defined in section 151(e)(4))" and inserting in lieu thereof "educational organization described in section 170(b)(1)(A)(ii)".

Section 1.511 [Deleted]

3. Paragraph (j)(1)(iii) is amended by deleting "section 512(b)(17)" and inserting in lieu thereof "section 512(b)(15)".

4. Paragraph (1)(5) is amended by deleting "section 512(b)(15)" each place that it appears, and inserting in lieu thereof "section 512(b)(13)."

Section 1.512(b)-1 Modifications.

* * * * *

(d) Gains and loses from the sale, etc. of property. (1) * * *

(2) There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is "covered." However, income from the lapse or termination of an option is excludable only if the option is written in connection with

the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

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Section 1.514 [Amended]

Par. 4. Section 1.514(b) is deleted.

Section 1.514(b)-1 [Amended]

Par. 5. Paragraphs (b)(2)(ii) and example (3) of (b)(3) of Section 1.514(b)-1 are amended by deleting "section 512(b)(15)" each place that it appears and inserting in lieu thereof "section 512(b)(13)".

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

Jerome Kurtz,
Commissioner of Internal Revenue.

Approved: July 5, 1979.
Donald C. Lubick,
Assistant Secretary of the Treasury.

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