

T. TRAVEL TOUR PROGRAMS -- EFFECT ON IRC 501(c) EXEMPTION AND UBIT LIABILITIES

Introduction

Most of us, as members of professional associations or unions, alumni of universities, and participants in civic and religious organizations, have been solicited by these organizations to take advantage of their travel tour programs. In recent years, the involvement of exempt organizations in travel tour activity has been ever increasing. The Sunday New York Times travel section, for example, regularly contains articles on exempt organizations' travel programs. The article in the March 20, 1977 issue on travel tours sponsored by many exempt American museums is particularly illustrative.

The dual attraction of providing low-cost travel for members and/or for the general public and earning income without large expenditures of funds and manpower has undoubtedly encouraged exempt organizations to undertake the sponsorship of travel tours.

In a typical situation, an exempt organization usually provides "package tours" from wholesalers which include land arrangements along with air transportation. Wholesalers pay the organizations, depending on the number of participants and the price of the tour, a fee for each participant on the tour. In many cases, the sole responsibility of the exempt organization is to provide promotional copy to members (this usually is provided by the wholesaler and mailed by him directly to members), receive deposits which are transmitted to the wholesaler and receive a rebate based on the number of participants and the tour price. In such cases, the exempt organization generally assumes no financial responsibilities. In other cases, however, the exempt organization may play a large, even dominant, role in running the tour program including the hiring of employees to serve as tour leaders.

Information available indicates that the following types of exempt (or claiming to be exempt) organizations are the most active in arranging travel tours:

- (1) Religious, charitable and educational organizations exempt from Federal income tax under IRC 501(c)(3);
- (2) Civic organizations exempt under IRC 501(c)(4);

- (3) Unions under IRC 501(c)(5);
- (4) Professional organizations under IRC 501(c)(6);
- (5) Social clubs exempt under IRC 501(c)(7); and
- (6) Fraternal beneficiary associations exempt under IRC 501(c)(8).

For organizations seeking exemption under section 501(c)(3) which offer travel tours as a substantial or primary part of their activities, there are some established published precedents which give guidelines for evaluating these activities as being charitable and/or educational. For organizations seeking exemption under other sections of IRC 501(a), there is no published precedent. Further, and aside from whatever exemption is an issue, income received by organizations from the sponsorship of travel tours may constitute unrelated trade or business income and thus be subject to IRC 511 tax. A landmark precedent in the UBIT area on the subject of sponsorship of travel tours by exempt organizations is Revenue Ruling 78-43, 1978-1 C.B. 164.

There is, of course, much controversy in this area as evidenced by the American Society of Travel Agents v. Blumenthal, 75-1 USTC 9484; affirmed, U.S. Court of Appeals, D.C., 77-2 USTC 9649. The suit was brought to compel the Service to revoke the tax-exempt status of several organizations that arrange travel tours and receive substantial income, and, in the alternative, to compel the Service to tax, as unrelated business income, amounts received by exempt organizations from their preparation of tour packages. The case was dismissed by the court following Eastern Kentucky Welfare Rights Organization, 426 U.S. 26 (1975), 1976-2 C.B. 609. The courts in ASTA held that the plaintiff lacked standing to maintain the action because the plaintiffs failed to show any injury to themselves from an existing situation or any prospective improvement were that situation to be changed.

With this introduction, the following in-depth discussion will examine the role of exempt organizations in the "wonderful world of travel" both from the effect on exemption (Part 1) and UBIT (Part 2) standpoints.

1. Travel Tours - Effect on Exemption

a. IRC 501(c)(3)

IRC 501(c)(3) provides the most published precedent. Subject organizations offering these tours are often membership organizations ranging from educational and historical groups to alumni associations. The offerings can range from a weekend in New York City to a month on the Costa del Sol. Trips may include the possibility of combining ostensibly educational experiences with traditional recreational activities. Tours, for example, may provide the opportunity to dig in ancient burial grounds in Hawaii while also providing the opportunity to acquire a tan at Waikiki Beach and sip a Mai Tai.

An organization exempt under IRC 501(c)(3) must be organized for charitable, religious, educational, scientific, literary, etc. purposes. In order for an organization to conduct "travel tours" as a primary purpose and activity and be exempt (or remain exempt) under IRC 501(c)(3), the tours must further the exempt purposes delineated.

In determining whether travel activities further an exempt purpose, the Service has published several revenue rulings covering various aspects of this area. Perhaps the clearest example is Rev. Rul. 77-430, 1977-2 C.B. 194. In Rev. Rul. 77-430, an organization which operated a religious retreat where recreational facilities were available was recognized as exempt. The organization's activities were conducted at a rural lakeshore site donated to it by its founder. Although no fees were charged for the retreats, participants were encouraged to contribute to the organization to whatever extent possible. Activities of a religious nature were scheduled on an hourly basis throughout the day. Although no recreational activities were scheduled, there was a limited amount of free time in which the participants could relax and enjoy the facilities. The Rev. Rul. determined that the use of these facilities under these circumstances were incidental to the organization's purpose of advancing religion.

The text of Rev. Rul. 77-430 is extracted below:

Religious; weekend retreat center. An otherwise qualifying non-profit organization that conducts weekend religious retreats, open to individuals of diverse Christian denominations, at a rural lakeshore site at which the participants may enjoy the recreational facilities in their limited amount of free time and that charges no fees qualifies for exemption as operated exclusively for religious purposes.

Rev. Rul. 77-430

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for religious purposes.

The organization was formed for the purpose of conducting weekend religious retreats open to individuals of diverse Christian denominations. The retreats are conducted by ministers and priests of the various denominations. The activities engaged in at the retreats are group and individual prayer, lectures, reading, and meditation. Such activities are generally scheduled on an hourly basis throughout the day. Although no recreational activities are scheduled, there is a limited amount of free time in which the participants may relax and enjoy the facilities.

The organization conducts its retreats at a rural lakeshore site donated to it by its founder. A building containing dormitory space, meeting rooms, eating facilities, and a lounge was constructed on the site by the founder and donated to the organization.

The organization publishes a newsletter that is mailed to anyone interested. It publicizes upcoming retreats, solicits financial support, and includes material on religious topics.

No fees are charged for the retreats, but participants are encouraged to contribute to the organization to the extent possible. The organization is supported by contributions from the general public and by donations from retreat participants.

Section 501(c)(3) of the Code provides for exemption from Federal income tax of organizations organized and operated exclusively for charitable or religious purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations includes in its definition of the term "charitable" the advancement of religion.

By conducting religious retreats in the manner described, the organization is engaged in the advancement of religion. Although the facilities are conducive to recreational activities, the use of the facilities under these circumstances for such purposes is incidental to the organization's purpose of advancing religion. Accordingly, it is operated exclusively for religious purposes and, thus, is exempt from Federal income tax under section 501(c)(3) of the Code.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Application for

Recognition of Exemption, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See sections 1.501(a)-1 and 1.508-1(a) of the regulations.

In counterpoint to Rev. Rul. 77-430, the Service denied exemption to the travel organization in Rev. Rul. 77-366, 1977-2 C.B. 192. The organization described therein had a stated purpose of providing a continuing educational program in an atmosphere conducive to spiritual renewal for ministers, members of churches, and their families. The organization's only activities consisted of the regular arranging for and conducting of winter cruises. Besides activities furthering religious and educational purposes, the cruises provided extensive social and recreational activities. Approximately four hours on each of nine days the ship was at sea were spent in lecture periods, discussions and workshops lead by theologians and religiously-oriented psychologists. A day was spent at each of five different ports of call where arrangements were made for general sightseeing tours and shopping opportunities. At three ports of call, programs were available to enable participants to spend minor portions of their time ashore meeting with local church leaders, attending worship services, and/or visiting mission projects.

The text of Rev. Rul. 77-366 is extracted below:

Qualification; religious; educational tours. A nonprofit organization that arranges and conducts winter-time ocean cruises during which activities to further religious and educational purposes are provided in addition to extensive social and recreational activities is not operated exclusively for exempt purposes and does not qualify for exemption.

Rev. Rul. 77-366

Advice has been requested whether the nonprofit organization described below, which otherwise qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, is operated exclusively for charitable purposes.

The organization's stated purpose is to provide a continuing educational program in an atmosphere conducive to spiritual renewal for ministers, members of churches, and their families. The organization's only activities consist of the regular arrangement and conduct of fourteen-day winter-time cruises on chartered ships. In addition to the usual cruise activities, the programs conducted on each cruise include a schedule of lectures, discussion groups, and special interest workshops on religious topics, at which attendance is not required. The cruises are

only advertised in periodicals published by religious denominations. Clergy normally account for about one-fourth of those who go on each cruise.

For approximately four hours on each of the nine days the ship is at sea, lectures, discussions, and workshops are led by theologians and religiously-oriented psychologists. The remainder of the time is available for meals, recreational activities, and social functions. Many of the social and recreational functions are arranged as part of the cruise, and recreational facilities are readily at hand for use. A day is spent at each of five different ports of call where arrangements are made for general sightseeing tours and shopping opportunities. At three of the ports of call, the cruise-sponsored programs also enable the participants to spend minor portions of their time ashore meeting with local church leaders, attending worship services, and/or visiting mission projects.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations that are organized and operated exclusively for religious, charitable or educational purposes. This statute has been construed as requiring all the resources of the organization to be applied to the pursuit of one or more of the exempt purposes therein specified. The presence of a single nonexempt purpose, if substantial in nature, will preclude exemption. *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945), Ct. D. 1650, 1945 C.B. 375.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations defines the term "charitable" to include the advancement of religion or education.

In this case, the organization accomplishes both charitable and non-charitable purposes through its cruises. The lectures, discussions, workshops, and some of the activities on shore further religious and educational purposes. However, the extensive amount of time, energy, and other resources which are regularly devoted to the conduct of social and recreational activities, together with the manner in which such activities are scheduled in relation to other cruise programs, and all the other attendant facts and circumstances here present demonstrate that the organization's conduct of such social and recreational activities serve substantial independent purposes of a noncharitable nature.

Accordingly, the organization does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code because it is not being operated exclusively for exempt purposes.

We shall return to Rev. Rul. 77-366, after considering the trilogy of IRC 501(c)(3) revenue rulings concerning students and travel tours.

In Rev. Rul. 67-327, 1967-2 C.B. 187, it was held that an organization that arranges summer tours for the students and faculty of an educational organization

was not exempt under section 501(c)(3). While the organization was owned and operated by the university, and the tour participants were restricted to members of the student body and faculty, the purpose was found to be the providing of vacations.

The text of Rev. Rul. 67-327 is extracted below:

Rev. Rul. 67-327

A nonprofit organization formed for the purpose of arranging group tours for students and faculty of a university to allow them to travel abroad and which has no other activities is not entitled to exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The Internal Revenue Service has been asked whether a nonprofit organization formed for the purpose of promoting and arranging group tours for students and faculty of a university who wish to travel abroad qualifies for exemption from Federal income tax as an educational organization under section 501(c)(3) of the Internal Revenue Code of 1954.

The organization assists in forming groups of persons having a common affiliation with a university and who are interested in chartering transportation for foreign travel. As agent for each group it collects the estimated pro rata share of the charter and administrative costs. The organization arranges for the transportation, pays the carrier, retains a sum to defray its expenses, and returns any balance to the group members. The organization has no other activities.

Section 501(c)(3) of the Code provides for the exemption of organizations that are "organized and operated exclusively" for educational purposes.

Section 1.501(c)(3)-1(d)(3)(i)(a) of the Income Tax Regulations defines the term "educational" as the instruction or training of the individual for the purpose of improving or developing his capabilities.

The arranging of group tours is not in itself the instruction or training of the individual for the purpose of improving or developing his capabilities. In view of the organization's stated purpose and activities, it does not qualify for tax exemption under section 501(c)(3) of the Code.

Rev. Rul. 67-327 was distinguished by Rev. Rul. 69-400, 1969-2 C.B. 114, which found that an organization which sponsored a foreign educational program was exempt under section 501(c)(3). While this organization performed extensively in the travel tour arrangement area, it restricted this activity to

assistance for students it sponsored for course work in foreign universities. The travel activity was found to be in support of its exempt purposes.

The text of Rev. Rul. 69-400 is extracted below:

A nonprofit organization that selects students and faculty members who are interested in a particular foreign history and culture and enrolls them at foreign universities qualifies for exemption under section 501(c)(3) of the Code; Revenue Ruling 67-327 distinguished.

Rev. Rul. 69-400

Advice has been requested whether a nonprofit organization formed and operated as described below qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The organization was formed to enable students and faculty members of United States schools who have a serious interest or background in a particular foreign history and culture to obtain a better understanding and become more knowledgeable in those matters. The organization accomplishes its purposes by selecting and enrolling qualified individuals in courses of study at foreign universities, arranging for transportation to and from the respective country, and arranging for on-site tours conducted by local scholars to complement classroom study in the particular country. A selection committee ascertains the bona fide nature of the reasons for individuals applying for participation in the organization's program. The organization is financed by fees, grants, and contributions.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term "charitable" includes the advancement of education.

Under these circumstances, by selecting and enrolling participants at various foreign universities, arranging for transportation, and arranging tours that complement classroom studies, it is held that the organization is advancing education. Accordingly, the organization qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

The facts set forth above are distinguishable from Revenue Ruling 67-327, C.B. 1967-2, 187, wherein the sole purpose and activity of the organization was to arrange group tours for students and faculty members of a university.

Even though an organization considers itself within the scope of this Revenue Ruling, it must (in order to establish exemption under section 501(c)(3) of the Code) file an application on Form 1023, Exemption Application, with the District Director of Internal Revenue for the internal revenue district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.

Rev. Rul. 67-327 was further distinguished by Rev. Rul. 70-534, 1970-2 C.B. 113. Rev. Rul. 70-534 describes an organization which conducted travel study tours that include courses on the culture of the United States, foreign countries, and nature studies taught by certified teachers. It was held exempt under IRC 501(c)(3). The Rev. Rul. found persuasive the fact that the tours were in fact courses conducted by certified teachers, which included lectures, instruction, preparation of reports, recitation, examinations, and the issuance of grades.

The text of Rev. Rul. 70-534 is extracted below:

A nonprofit organization whose primary activity is conducting travel study tours that include courses on the culture of the United States, foreign countries, and nature studies taught by certified teachers is exempt under section 501(c)(3) of the Code.

Rev. Rul. 70-534

Advice has been requested whether the nonprofit organization described below qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The organization was formed for the stated purposes of educating individuals about the culture of the United States, the culture of other countries, and nature studies.

The primary activity of the organization is conducting travel study tours to various States, foreign countries, and National Parks. The study tours, which are conducted by teachers and other personnel certified by a State board of education, normally last for several weeks.

The study tours are directed towards students but are open to all who agree to participate in the study program required during the tour.

The study program consists of junior college level courses related to the area being visited by the tour. Five to six hours per day are devoted to organized study, preparation of required reports, lectures, instruction, and recitation by the students. A library of books, pamphlets, and material related to the courses being taught are carried on the tour. Examinations are administered at the end of the

tour and each student is graded for the course. The State board of education allows school credit for participation in the organization's program.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for educational purposes.

Section 1.501(c)(3)-1(d)(3) of the Income Tax Regulations defines the term "educational" as the instruction or training of the individual for the purpose of improving or developing his capabilities.

Since the courses, which are conducted by certified teachers, consist of lectures, instruction, preparation of reports, recitation, examinations, and the issuance of grades, the organization is performing the instruction or training of the individual for the purpose of improving or developing his capabilities.

Accordingly, it is held that the organization is exempt from Federal income tax under section 501(c)(3) of the Code. For a situation where an organization arranging travel tours does not qualify for exemption under section 501(c)(3) of the Code, see Revenue Ruling 67-327, C.B. 1967-2, 187, which describes an organization the sole activity of which was arranging group tours for students and faculty of a university who wish to travel abroad.

Even though an organization considers itself within the scope of this Revenue Ruling, it must file an application on Form 1023, Exemption Application, in order to be recognized by the Service as exempt under section 501(c)(3) of the Code. The application should be filed with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the regulations.

In comparison to the travel activities of the organizations in Rev. Ruls. 69-400, and 70-534, the cruise activities of the organization in Rev. Rul. 77-366 sponsoring the cruises are far less exclusively devoted to educational or charitable programs in regard to time spent vis-a-vis social or recreational activities. There was, in fact, no comparison to the formal student faculty facts in 69-400 and 70-534. In 77-366, it was held that the organization's conduct of the extensive social and recreational activities served substantial independent purposes of a non-charitable nature and, therefore, the organization could not qualify for exemption under section 501(c)(3).

Before leaving the IRC 501(c)(3) area, it should be pointed out that there are many potential issue areas that are not covered by publication. This is true whether we are concerned with effects on exemption or, probably more significantly, the

possibility of UBIT liabilities (where the travel tour programs are not substantial in respect to a particular organization's primary purpose or activity).

For example, consider the hypothetical tours run by the scientific/geographical organization for lay members or the general public to the Outbacks of Australia to dig up the burial grounds of Bronze Age man, or a nature society's expedition into the Okefenokee Swamp on the search of the rare, if not extinct, ivory-billed woodpecker. Trips such as described above are obviously not the travel tour endeavors one goes on to escape Northern winters or everyday routines in the traditional sense as would be the case with the tropical cruise activities in Rev. Rul. 77-366. On the other hand, the non-traditional tours probably would not have the formal educational aspects and academic credits associated with the programs described in Rev. Ruls. 69-400 and 70-534.

Each individual case must be resolved on the particular facts and circumstances, and the National Office will consider further publication in this area when the cases are received through technical advice or perhaps proposed transaction ruling requests.

Discussion in the IRC 501(c)(3) area will continue in the UBIT discussion in Part 2.

b. Other IRC 501(c) Exemptions

In contrast to IRC 501(c)(3), there have been no revenue rulings published concerning the effect of travel tour programs on exemption under other IRC 501(c) sections. The discussion that follows acknowledges this fact. The discussion should also be read in conjunction with the discussion of UBIT in Part 2.

Civic organizations are examples of social welfare organizations under IRC 501(c)(4). So are certain kinds of garden clubs which may arrange tours to local and national flower festivals. Many of these organizations engage in social activities on a varying scale. An example might be an organization, consisting of retired persons, whose purposes are to provide for the needs of retired persons and advance their interests. Membership may be open to any person who is at least 55 years of age. The organization carries out its bonafide exempt purposes through legislative activities and various other programs for the benefit of retirees. As its primary activity, foreign travel tours are arranged on a regular basis, with members having a choice of different group tours each year. The organization operates the

tours at cost. If these programs do not further exempt purposes, they may thus jeopardize the exempt status of the organization.

Generally, although it is recognized that a social welfare membership organization may carry on incidental social and recreational activities, mass travel tour activity might go beyond this. It would be arguable, however, by the organization that travel activities further its exempt purposes of advancing the interests of retired persons. The organization offers travel tours to the membership to provide them interesting and satisfying things to do with their time. It could be said that travel tours, especially those oriented to elderly people, would accomplish this. On the other hand, serious questions are raised as to whether such a relatively luxurious item such as foreign travel, probably beyond the financial reach of most members of the organization, is sufficiently broad-based to qualify as an exempt social welfare activity. In addition, it seems that the providing of travel service to retired people is a service that is otherwise commercially available to them. If retired people are interested in travel, there are commercial agencies that can take care of their interests.

As can be seen, there exists a close question that could easily turn on the complete factual pattern of a given case.

One of the more complex areas involving travel tours concerns professional organizations exempt under IRC 501(c)(6) which sponsor so-called "professionally related" or educational travel tour packages. Section 501(c)(6) of the Code provides, in part, for exemption of business leagues not organized for profit. Trade and professional organizations, such as bar associations, medical associations, etc., are traditionally exempt under this category.

A description of a typical professional related travel tour program may be similar to the following: The tour is custom-designed to afford interested members (families and associates) an opportunity to visit and learn first-hand the cultural, historical and educational programs of foreign lands. The tour offers a unique professional experience at reduced cost not usually available to persons traveling on an individual basis.

If such activities constitute a primary purpose of such organizations, exemption could be jeopardized. It is more likely, however, that such activity may be less than primary and, as such, a UBIT issue. This will be further discussed in Part 2.

One significant court case which involved an organization under IRC 501(c)(6) is The American Automobile Association v. Commissioner, 19 TC 1146, (1953). In that case, AAA, in addition to civic, insurance and safety standard activities, maintained as its primary activity, a travel department which prepared and published tour books, accommodation directories, maps, service station directories, triptiks and other travel material for both domestic and foreign travel. The Court held that the Association was primarily a service organization performing services for members for less than they could be obtained elsewhere and, therefore, not an exempt league under section 101(6) of the Code (now IRC 501(c)(6)). The Court further stated that the Association was engaged in commercial activities in the solicitation and sale of advertising, in the sale of travel publications and other materials and supplies to affiliated clubs, and in the operation of its foreign travel department.

Social clubs under IRC 501(c)(7) represent another aspect of the travel tour question. Prior to the Tax Reform Act of 1976, social clubs had to be organized "exclusively" for the pleasure, recreational and other non-profitable interests of its members. The Tax Reform Act of 1976 changed the requirement to "substantially all," thus providing a more liberal exemption rule for social clubs.

Because of the inherently recreational nature of travel tours, activities involved in arranging travel tours for members would likely be considered in furtherance of the recreational purposes for which a social club would be exempt. For example, the Service would likely recognize exemption under IRC 501(c)(7) of a travel club which was limited to local community members and provided travel trips for its voting members. Facts indicating that participating member/travelers stayed together during the entirety of the trips, in contrast to merely staying together only for the transportation, would support conclusions that such trips furthered membership, fellowship and, therefore, exempt social club purposes.

On the other hand, the Service is likely to be adverse with facts indicating substantial participation by non-members, or so-called members paying a nominal membership fee to enable them to participate in travel tours.*

*See Council of British Societies in Southern California v. U.S., USDC. Cen Dist. Cal., September 27, 1978, CCH PF Reporter, para 7557.

The above has discussed travel tours as they relate to organizations under IRC 501(c)(4), (6), and (7). Consideration should not be restricted to just these organizations. Many other varieties of exempt organizations are also engaged in or preparing travel tour packages. The above discussion, and that of unrelated business income tax, to follow in Part 2, is also relevant to these other organizations.

2. Travel Tours and UBIT

a. General

As a general rule, organizations exempt under IRC 501(a) may engage in unrelated trade or business activities without jeopardizing its exemption so long as the organizations remain primarily engaged in activities which are in furtherance of exempt purposes.

Prior to the Tax Reform Act of 1969, only certain organizations (those exempt under 501(c)(3), with the exception of churches, (c)(5), (c)(6), (c)(14)(b) and (c), and (c)(17)) were subject to the tax on unrelated business income. The Tax Reform Act of 1969 extended sections 511 through 514 to include practically all organizations exempt under section 501(a). Organizations described in IRC 501(c)(1) constitute exceptions. Federal credit unions, recreational leagues, and other entities chartered as tax exempt by the Congress, for example, may run travel tours, regardless of unrelatedness, and still be immune from UBIT liabilities. To the extent relevant here, exempt organizations are subject to UBIT for income-producing trade or business activities if such activities are regularly carried on, not conducted by uncompensated labor and, most importantly, are not substantially related to exempt purposes. These rules are somewhat modified for social clubs under IRC 501(c)(7) and voluntary employees' beneficiary associations under IRC 501(c)(9) which are subject to special unrelated trade or business rules under IRC 512.

Exempt social clubs are not taxed on "exempt function income" such as income from members in consideration for services that further social or recreational purposes. For example, if a club is exempt under IRC 501(c)(7) because it is organized as a social and travel club, any income derived from travel tours provided only to bonafide members would likely constitute "exempt function income" and not be taxed. These travel tours, of course, would have to be more than just a transportation service and provide a full group program of social and

recreational activities as noted in the discussion in Part 1, concerning effect of travel tours on exemption.

b. Substantially Related

For most IRC 501(a) organizations, IRC 513 states that "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of its exempt purpose.

Regs. Section 1.513-1(d)(2) provides, in relevant part, that a trade or business is "related" to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of exempt purposes. In addition, the causal relationship must be a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the performance of services from which the gross income is derived must "contribute importantly" to the accomplishment of exempt purposes.

The landmark ruling in this area is Rev. Rul. 78-43, 1978-1 C.B. 164. The full text of Rev. Rul. 78-43 is extracted below:

Unrelated trade or business; alumni association's travel tour program. A travel tour program operated by a university alumni association for members and their families, under which the association, working with various travel agencies, schedules several tours annually to destinations around the world, mails out promotional material, accepts reservations, and is paid a fee by the travel agencies on a per person basis, is an unrelated trade or business within the meaning of section 513 of the Code.

Rev. Rul. 78-43

Advice has been requested whether, under the circumstances described below, the operation of a travel tour program by a university alumni association, exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, constitutes unrelated trade or business within the meaning of section 513.

The stated purpose of the association and, the basis for its exemption under section 501(c)(3) of the Code, is the promotion of education by assisting a given university, both financially and otherwise, and by encouraging its member alumni to do the same. It implements this purpose principally by working to raise

funds for the support of the university. It also publishes an alumni newsletter and maintains an alumni center for its members on the campus of the university.

The association has instituted a travel tour program that is open to all current members of the alumni association and their immediate families. Approximately ten tours are scheduled annually to various destinations around the world.

It works with various travel agencies in planning package tours, mails out promotional brochures on tours to its members, and receives reservations. Each travel agency it uses pays it a per person fee.

There is no formal educational program conducted in connection with these tours, and they differ in no substantial way from regular commercially operated tours. The association provides an employee to accompany each tour to serve as a tour leader.

Section 513(a) of the Code provides that the term "unrelated trade or business" means any trade or business the conduct of which is not substantially related to the exercise or performance of an organization's purpose or function constituting the basis of its exemption under section 501, aside from its need for income or funds or the use it makes of the profits derived.

Section 1.513-1(c)(1) of the Income Tax Regulations provides in substance that to determine whether trade or business is "regularly carried on," one must look to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

By making available various travel tours to its members in the manner described, the association is furnishing its members with a regularly carried on commercial service not substantially related to the educational purposes of the organization. The provision of travel tours is not in itself an educa-[ILLEGIBLE] satisfaction of the Secretary or his delegate, that under all the facts and circumstances the contractual obligation to pay the advanced royalties was achievement of the association's exempt purposes, the activity does not contribute

importantly to the accomplishment of the association's purposes that are the basis for its exemption under section 501(c)(3) of the Code.

Accordingly, under the circumstances described, the sale of travel tours by the association to its members is unrelated trade or business within the meaning of section 513 of the Code.

The concern in Rev. Rul. 78-43 is whether the travel tour program of a IRC 501(c)(3) university alumni association is an unrelated trade or business within the meaning of IRC 513. The tour program, of approximately ten tours per year, was open to all members of the association and their immediate families. The association worked with various travel agencies in planning package tours, mailed out promotional brochures on tours to its members and received reservations. Each travel agency paid it a per person fee. There was no formal educational program conducted in connection with these tours. The association provided an employee to accompany each tour to serve as a tour leader.

Rev. Rul. 78-43 found that by making available various travel tours to its members, the association was furnishing a commercial service not substantially related to the educational purposes of the organization. As noted in the Rev. Rul., providing travel tours was not a per se educational activity. Rev. Rul. 67-327, discussed supra, was cited.

Rev. Rul. 78-43 held that because there was no causal relationship between the travel tour activity and the achievement of the association's exempt purpose, the travel tours did not contribute importantly to the exempt purpose of the organization and thus constituted an unrelated trade or business.

As a final note, the extent of participation by the association in the running of the tours, clearly eliminates any consideration of the IRC 512(b)(2) modification from unrelated trade or business income for royalty income. See discussion of the royalty income modification at p. 521 of this EOATRI textbook.

In discussing travel tours in the context of exemption in Part 1, attention was drawn to the "professionally related" travel programs of professional organizations exempt under IRC 501(c)(6). These tours should be considered as potential UBIT issues. In repetition of the Part 1 discussion, a representative travel tour program may feature the following characteristics: a custom-designed package to provide interested members (and families of members) an opportunity to visit and learn first-hand the cultural, historical and educational aspects of foreign lands with emphasis on the particular field the professional organization represents. The tour

usually offers the experience not usually available to persons traveling on an individual basis.

The following representative itineraries may be typical examples of this type of travel tour. The trips described are oriented toward the lawyer members of a bar association, but with a few language substitutions could just as easily be directed toward members of medical associations, etc.

(i) Itinerary 1

**Professionally Related
Travel Programs**

These custom designed cultural, historical and educational programs will afford interested members of the (families and associates) an opportunity to visit and learn first hand the legal and judicial systems of foreign lands. Based upon lower-cost group rates, these sponsored programs are conducted and arranged at no expense to the Bar.

Eastern Europe Exotic Adventure

Departure July 17,; return August 5,
Visit Budapest, Bucharest, Moscow, Istanbul, London
Cost per person double occupancy, \$1569 plus 10% service (\$153.90).

Italian Rhapsody

Departure May 5,; return May 19,
Visit Milan, Santa Margherita (Italian Riviera), Florence, Rome and Capri
Cost per person double occupancy, \$1315 plus 10% service (\$131.50).

Greek Odyssey

Departure September 17, return October 1
Cost per person, double occupancy, \$1229 plus 10% service (\$122.90).

To receive full details and itinerary information on the __ programs, please contact:

(ii) Itinerary 2

THESE FIRST CLASS FEATURES:

- 6 nights deluxe accommodations in Athens
- 4-day Classical Tour by deluxe motorcoach
- 4-day Cruise to the Aegean Islands
- Continental Breakfast/Dinner-Daily-Athens
- 3 meals daily during Classical Tour and on the Cruise
- Outside Cabins on the Cruise

ADDITIONAL FEATURES:

- Roundtrip Economy Air Transportation via Scheduled Carrier
- Comprehensive Sightseeing Program
- "Sound & Light Spectacle" and Greek Folk Dancing Performance in Athens
- Professional Visitations and Exchanges
- All portorage, transfers, entrance fees

ITINERARY:

1st day NEW YORK Check in at Int'l Airport for overnight flight to Greece.

2nd-4th days ATHENS Upon arrival transfer to Hotel. Sightseeing includes National Archeological Museum, the Acropolis, Theatre of Dionysos, the Royal Palace. Evening "Sound & Light Spectacle" on Pnyx Hill followed by performance of Greek folk dances. Excursion to Cape Sounion to see the sun set over the white marble Temple of Poseidon.

5th-8th days 4-DAY CLASSICAL TOUR OF GREECE See the Corinth Canal, Old Corinth, Mycenae, Epidaurus and Nauplia (overnight). Continue to Tripolis, Olympia (overnight) then drive to Aegion via Patras, cross the Corinthian Gulf by ferry boat and drive up to Delphi (overnight). Depart after lunch for the Byzantine Monastery of St. Luke. Evening return-Athens.

9th day ATHENS Free day in Athens.

10th-13th days 4-DAY AEGEAN ISLANDS CRUISE In the afternoon, transfer to the port of Piraeus for embarkation on 4-day Cruise visiting Hydra, Santorini, Heraklion, Rhodes, Ephessos and Mykonos.

14th day ATHENS Arrive in Piraeus in early morning for transfer to Hotel. While in Athens visits to local courts and meetings with local Bar members will take place.

15th day ATHENS/NEW YORK Transfer to airport for early afternoon flight to New York.

Is the statement in the above material, "While in Athens visits to local courts and meetings with local Bar members will take place," sufficient to classify this entire package as conducted in furtherance of the organization's exempt purpose? It is doubtful!

In any event, close scrutiny should also be given to the amount of time spent on sightseeing and social activities in relation to the amount of time actually spent in activities which could be possibly arguable as being in furtherance of exempt purposes.

Although there are no revenue rulings on professional organizations and UBIT issues involving travel tours, there is some analogy in IRC 162 revenue rulings. Consider Rev. Rul. 74-292, 1974-1 C.B. 43. In the latter, a doctor/taxpayer claimed business expense deductions under IRC 162 for the cost of a 14-day trip to two foreign countries sponsored by his professional organization. The object of the trip was to combine travel to certain cities in each of two countries with three professional seminars in each country. Each seminar was to be of two hours duration and were to be held in a different city. In addition, optional side tours were made to well-known tourist attractions in each of the countries visited. The doctor received a Certificate of Continuing Education in Medicine at the conclusion of the trip.

The taxpayer paid to the travel agency the cost of air fare, hotel accommodations, meals, a special escort, transportation to and from hotels, and tips. No part of the cost was attributable to the seminars, which were arranged for him by the sponsoring professional association.

Rev. Rul. 74-292 found the following:

- (1) the six two-hour professional seminars did not convert into a business trip what was in all respects a vacation;
- (2) the expenses incurred for travel were not related primarily to the taxpayer's trade or business; and
- (3) no other expenses were incurred that were directly attributable to the conduct of the taxpayer's trade or business.

As found in the Ruling, the participation in some incidental activity by the taxpayer related to his trade or business would not change what otherwise was a vacation trip into a business trip.

Rev. Rul. 74-292 found that the taxpayer's entire cost of the trip was not an ordinary and necessary business expense under IRC 162. Analogy should be found in the UBIT area, for example, in the type of "professionally-related" trip represented above.

The full text of Rev. Rul. 74-292 is extracted below:

Travel expenses; doctor attending professional seminars abroad.

Travel expenses incurred by a doctor on a trip which combined vacation travel abroad with attendance at brief professional seminars in each of the countries visited are not deductible business expenses under section 162 of the Code but are non-deductible personal expenses under section 262.

Rev. Rul. 74-292

Advice has been requested concerning the Federal income tax treatment of expenditures by an individual taxpayer for a trip to two distant countries under the circumstances described below.

A taxpayer, engaged in the active practice of medicine in the State in which he lives, is a member of a professional association. During the taxable year, the association sponsored a 14-day trip to two distant foreign countries and the arrangements for the trip were handled by a travel agency.

The object and design of the trip was to combine travel to certain cities in each of the two countries with three professional seminars in each country. Each seminar was to be of two hours duration and was to be held in a different city. Three seminars were held in each country at the hotels where the taxpayer stayed and he signed attendance sheets at all of them. He also made an optional side trip to a well-known tourist attraction in each of the countries visited. At the conclusion of the trip he received a Certificate of Continuing Education in Medicine.

The taxpayer paid to the travel agency the cost of air fare, hotel accommodations, meals, a special escort, transportation to and from hotels, and tips. No part of the cost was attributable to the seminars, which were arranged for him by the sponsoring professional association.

Section 162(a) of the Internal Revenue Code of 1954 provides for the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses

(including amounts expended for meals and lodging) while away from home in the pursuit of a trade or business. Section 262 provides, with exceptions not here material, that no deduction shall be allowed for personal, living, or family expenses.

Section 1.162-2(a) of the Income Tax Regulations provides, in part, that only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted. If the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses.

Under section 1.162-2(b)(1) of the regulations, if a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

Section 1.162-2(b)(2) of the regulations provides, in part, that whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends upon the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activities compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal.

In *Esfandiar Kadivar*, 32 CCH Tax Ct. Mem. 427 (1973), a doctor took a trip to several foreign countries. The trip was arranged by a medical association and travel arrangements were handled by a travel agency. The object and design of the trip was to combine travel to faraway cities with five medical seminars (each of one hour's duration) to be held at tourist hotels. No part of the cost of the trip was allocated by the travel agency to the seminars. The taxpayer attended all five seminars. The United States Tax Court stated that the trip was primarily for pleasure and the fact that a few hours were spent at brief medical seminars did not convert what was in all other respects a vacation into a business trip. The Court therefore held that since the cost of the trip was not incurred in any activity related to the taxpayer's trade or business no portion of such cost was deductible.

In the instant case the facts show that (1) the six two-hour professional seminars did not convert what was in all respects a vacation into a business trip;

(2) the expenses incurred for travel were not related primarily to the taxpayer's trade or business; and (3) no other expenses were incurred that were directly attributable to the conduct of the taxpayer's trade or business. The participation in some incidental activity by the taxpayer related to his trade or business will not change what otherwise was a vacation trip into a business trip.

Accordingly, the taxpayer's entire cost of the trip under the facts presented is not an ordinary and necessary business expense under section 162 of the Code, but rather is a non-deductible personal or living expense under section 262.

c. The Fragmentation Rule

IRC 513(c) and Regs. 1.513-1(b) provide that activities do not lose identity as a trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to exempt purposes.

This "fragmentation" rule may thus apply UBIT to segments of a travel program. An organization may offer travel programs that contribute importantly to its educational purposes and offer travel programs that do not contribute importantly to its educational purposes. In such instances, the organization should be subject to tax on the travel programs that are unrelated to its exempt purposes.

The fragmentation rule, promulgated ostensibly to cover advertising income fragmented from related publication income, has been applied to the sale of pharmaceutical supplies (section 1.513-1(b) of the Regulations; Rev. Rul. 68-374, 1973-1 C.B. 242) and museum gift shop sales (Rev. Rul. 73-105, 1973-1 C.B. 264). There is no reason why the principle may not be also applied to the travel tour area. For example, take the example of an organization exempt under IRC 501(c)(3) for the stated purpose of educating the community in world affairs, creating an informal public opinion and promoting wide understanding of world affairs. The organization's activities include sponsoring lectures and conducting travel tours for high school students and adults. The tours for the students are trips to the United Nations in New York and Washington, D.C. and are comparable to the class tours generally associated with American high schools. In contrast to the trips for the students, the organization also conducts trips for adults to areas known for their cultural and historical nature but are run comparably to tours conducted by commercial agents.

It would seem that use of the fragmentation rule would be particularly appropriate in examination of such an organization.

Rulings issued in the past (on audit years prior to 1967, before issuance of regulations on the fragmentation rule, or before 1970, when the fragmentation rule was codified as IRC 513(c)) may appear inconsistent today because issues may have been developed on the standpoint of the entirety of an organization's travel program instead of on its parts. If taken as a whole, a particular program may have been found to be substantially related. With the fragmentation rule, however, travel tour activities should now be evaluated on a piece-meal basis.

A further discussion of the fragmentation rule may be found in the topic on Museum Retailing found at p. 486 of this EOATRI textbook.

d. Exceptions From Unrelated Trade or Business -- Donated Labor, and the Intermittent Rule

IRC 513(a)(1) and the regulations thereunder provide an exception from the term "unrelated trade or business" for activities that are run with substantially all donated labor. This exception is not likely applicable in the travel tour area because of the need for great amounts of highly compensated and sophisticated labor and services.

A more valid potential exception lies in the intermittent regularly carried on exception to the requirement.

Section 512(a)(1) of the Code defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by Chapter 1 of the Code which are directly connected with the carrying on of such trade.

Section 1.513-1(c)(1) of the Income Tax Regulations provides in substance that to determine whether trade or business is "regularly carried on," one must look to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(c)(2)(ii) of the regulations provides in part that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. It also includes the further substantive rule that, in general, exempt organization business activities which are engaged in only discontinuously or periodically will

not be considered regularly carried on if they are conducted without the competitive or promotional effort typical of commercial endeavors.

Section 1.513-1(c)(2)(iii) of the regulations provides as follows:

Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

Intermittent travel tours that are commonly provided by a number of exempt organizations, such as the annual fund raising projects which may be also for the convenience of members, are not generally subject to UBIT, because the tours occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as regularly carried on.

Compare this to the facts in Rev. Rul. 78-43, supra, wherein the organization sponsored ten tours per year. The

Ruling clearly reasoned that such activity was regularly carried on commercial service activity.

Conclusion

In sum, travel tours of IRC 501(a) organizations, or organizations claiming exemption, deserve scrutiny for exemption and especially UBIT issues.

There is no doubt that there is considerable gray in this area. Resolutions of individual cases should rest on development of facts and circumstances utilizing the principles raised in this discussion. The National Office awaits new cases for possible publication.