

An organization, which is exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, regularly sells 'call' options on certain securities held in its investment portfolio. Held, the organization is engaged in an unrelated trade or business as defined in section 513 of the Code, and income realized by the organization from unexercised 'call' options is subject to the unrelated business income tax imposed by section 511 of the Code.

Advice has been requested whether income realized by an organization exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 from unexercised 'call' contracts (options) is subject to the unrelated business income tax imposed by section 511 of the Code.

A 'call' option, as referred to herein, is a transferable, bearer contract issued to a buyer (optionee) by an organization (issuer or optioner) for a cash payment (premium) upon delivery of the contract. The contract gives the buyer the right, at his option, to buy from the organization a certain number of shares of a specific stock at a fixed price on or before a stipulated date. Such option contracts terminate upon expiration of the stipulated date if they are not exercised.

The organization does not purchase stock for the purpose of issuing 'call' options, but offers 'calls' only on selected stocks held in its portfolio. 'Call' options are regularly issued by the organization from its large and varied portfolio of stocks.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations otherwise exempt from tax under section 501(c)(3) of the Code. The term 'unrelated business taxable income' is defined in section 512 of the Code, with certain exceptions, additions, and limitations, as the gross income derived by an organization from an unrelated trade or business regularly carried on by it, less allowable deductions directly connected with conducting such trade or business. Section 513 of the Code defines the term 'unrelated trade or business,' as 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 by such organization of its charitable, educational, or other purpose or function forming the basis for its exemption under section 501 of the Code.

The organization contends that the selling of 'call' options is a part of the management of its investments, and that this activity does not meet the definition of an 'unrelated trade or business,' within the meaning of section 513 of the Code. *Eugene Higgins v. Commissioner*, 315 U.S. 212 (1941), Ct. D. 1486, C.B. 1941-1, 339. It also relies on Senate Report No. 2375,

Eighty-first Congress, C.B. 1950-2, 483, at 506, relating to the Revenue Act of 1950, which states, in part, that dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because the Committee believed that they were 'passive' in character.

Section 512(b) of the Code excludes from the base of the tax on unrelated income, all capital gains, as well as certain other items of income. However, the fact that income from certain sources and activities is excluded from the computation of 'unrelated business taxable income' under the provisions of section 512(b) of the Code is not determinative of whether an organization is engaged in an unrelated trade or business.

Two tests must be met by an organization before an activity is considered an 'unrelated trade or business' for the purpose of the tax on unrelated business income: (1) The activity must be regularly carried on with sufficient consistency to indicate a continuing purpose of the organization to derive income from such activity, and (2) the activity must be unrelated to the exempt function or purpose of the organization. See section 1.513-1(a) of the Income Tax Regulations.

The selling of 'call' options by an organization is a separate activity from the management of its portfolio of securities. An organization can realize income from the sale of a 'call' or 'put' option without selling the underlying security.

Revenue Ruling 58-234, C.B. 1958-1, 279, provides that if a 'put' or 'call' (issued singly) is exercised, the premium is allocated as an adjustment to the price or cost of the underlying stock which is the subject of the option, so that capital gain may result. Where, however, a 'put' or 'call' issued singly expires without having been exercised, the premium received by the issuer or the writer is ordinary income. Although Revenue Ruling 58-234 is not determinative of whether the activity of writing 'call' options constitutes an unrelated trade or business as defined in section 513 of the Code, it recognizes that income from the sale of a capital asset is different from income realized by the seller of an option contract which expires without being exercised.

Revenue Ruling 63-183, C.B. 1963-2, 285, holds that an open end investment company which received more than 10 percent of its gross income from expired, unexercised 'put' and 'call' options does not qualify as a regulated investment company because of its inability to meet the limitations prescribed in section 851(b)(2) of the Code. Section 851(b)(2) of the Code includes as eligible income 'gains from the sale or other disposition of stock or securities.' That Revenue Ruling states in part:

However, when the optionee permits the 'put' or 'call' to expire without exercise, the premium the writer has

received for writing the option is not associated with, and has no relevance in, fixing the amount of gain from the disposition of any particular stock or securities. Nor can the premium be viewed as gain from the sale or other disposition of the option itself. (Emphasis added.)

Since the organization regularly engages in selling 'call' options from which it realizes some part of its income, it is engaging in an unrelated trade or business within the meaning of section 513 of the Code. Therefore, income realized by the organization from unexercised 'call' options is income from an unrelated trade or business, which is subject to the unrelated business income tax imposed by section 511 of the Code in the taxable year in which the failure to exercise the option becomes final. It is immaterial that income received by the organization from the sale of securities resulting from exercised options is excluded from the base of the unrelated business income by section 512(b) of the Code.