

ISSUE

In the two situations described below, is a school's furnishing of its tennis facilities unrelated trade or business under section 513 of the Internal Revenue Code and, if so, is income from these activities excluded from unrelated business taxable income as rent from real property under section 512(b)(3)?

FACTS

SITUATION 1.-TENNIS CLUB RUN BY A SCHOOL'S EMPLOYEES

A school is exempt from federal income tax under section 501(c)(3) of the Code and is classified as an educational organization described in section 170(b)(1)(A)(ii). The school's purposes are limited to those involving the advancement of education. The school's facilities include tennis courts and dressing rooms, which are employed during the regular academic year in the school's educational programs. For ten weeks during the summer the school operates a tennis club. For a fee, the general public is invited to join the club and thereby use the school's tennis courts and dressing rooms during designated periods. Two employees of the school's athletic department conduct the affairs of the club, including collecting membership fees and scheduling court time. The net income of the club is used for the exempt purposes of the school.

SITUATION 2.-TENNIS CLUB RUN BY A PROFESSIONAL USING SCHOOL FACILITIES

This Situation is the same as Situation 1, except that the school merely makes the facilities available to an unrelated individual for ten weeks at a fixed fee which does not depend, in whole or in part, on the income or profits derived from the leased property. The individual forms a tennis club and hires employees to administer the affairs of the club. Under a contract with the school, the individual must repair any damage to the facilities beyond normal wear and tear at the end of the ten weeks.

LAW

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations exempt under section 501(c)(3).

Section 512(a) of the Code defines 'unrelated business taxable income' as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less certain deductions, but with modifications provided in section 512(b). For purposes of determining unrelated business

taxable income, section 512(b)(3) excludes rents from real property.

Section 513(a) of the Code defines 'unrelated trade or business' of an exempt organization 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 constituting the basis for its exemption under section 501.

Section 513(c) of the Code provides that the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.512(b)-1(c)(5) of the Income Tax Regulations provides that rents from real property, for purposes of the exclusion from unrelated business taxable income, do not include payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms in hotels, boarding houses, or apartment houses furnishing hotel services, or for the use or occupancy of space in parking lots or warehouses. Generally, services are considered rendered to the occupant if they are for his or her convenience and are not those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The regulation further provides that supplying maid service constitute such service, whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash, are not considered services rendered to the occupant.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is 'related' to exempt purposes, in the relevant sense, only when 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. Section 1.513-1(d)(2) further provides that 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.

Rev. Rul. 76-402, 1976-2 C.B. 177, considered an exempt school that provides tennis courts, furnished dormitory rooms, linens, maid service, meals, and dining facilities to an individual for use by the individual in conducting a summer tennis camp. Rev. Rul. 76-402 assumed that the income was

taxable as income from an unrelated trade or business under section 513 of the Code and was not excludable from unrelated business taxable income under section 512(b)(3) and section 1.512(b)-1(c)(5) of the regulations as rent from real property.

ANALYSIS AND HOLDINGS

In this case, by furnishing tennis facilities in the above described situations, the school is performing services for the production of income, which constitutes a trade or business under section 513 of the Code. Since the school furnishes its tennis facilities during ten weeks of the year, it is engaging in a trade or business regularly carried on within the meaning of section 512. The exempt purposes of the school are limited to those involving the advancement of education. Furnishing tennis facilities in the manner described is not an activity that furthers the educational purposes of a school. Thus, this activity does not have a substantial causal relationship to the achievement of the school's exempt purposes, as required by section 1.513-1(d)(2) of the regulations. Accordingly, the school's furnishing of its tennis facilities in the above described situations is unrelated trade or business under section 513.

In Situation 1, as in Rev. Rul. 76-402, the school furnishes more than just its facilities. It operates the tennis club through its own employees, who perform substantial services for the participants in the tennis club. Accordingly, income from the school's furnishing of its tennis facilities through the operation of a tennis club in the manner described is not excluded from unrelated business taxable income as rent from real property under section 512(b)(3) of the Code and section 1.512(b)-1(c)(5) of the regulations.

In Situation 2, the school furnishes its tennis facilities to an unrelated individual without services and for a fixed fee which does not depend in whole or in part on the income or profits derived from the leased property. Unlike Situation 1, where the school itself provided services, the unrelated club operator hires employees to administer the affairs of the club. Accordingly, income from the school's furnishing of its tennis facilities through an individual operator is excluded from unrelated business taxable income as rent from real property under section 512(b)(3) of the Code and section 1.512(b)-1(c)(5) of the regulations.