

Unrelated income; allocation of membership receipts. In computing the amount of unrelated business taxable income from advertising in an exempt organization's periodical, the proper method of allocating membership receipts to circulation income under the formula in section 1.512(a)-1(f)(4)(iii) of the regulations is illustrated.

ISSUE

Under the circumstances described below, has a proper method of allocating membership receipts to circulation income under the formula set forth in section 1.512(a)-1(f)(4)(iii) of the Income Tax Regulations been applied?

FACTS

For 1980, an organization exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code had membership receipts of \$64,000 comprised of annual membership dues of \$64 paid by each of its 1,000 members. It publishes a monthly periodical, the readership content of which is related to its exempt purpose. The periodical also contains commercial advertising for which the organization received gross advertising income of \$20,000. Total periodical costs were \$30,000, of which \$5,000 was for direct advertising costs and \$25,000 was for readership costs. The periodical is distributed to all members at no additional charge. It is not sold or distributed to non-members. The organization's only other activity is related to its exempt purposes and produced receipts of \$25,000 with related expenses of \$70,000.

On its Exempt Organization Business Income Tax Return, Form 990-T, for 1980, the organization reported unrelated business income attributable to the sale of advertising as follows:

|  |                |
|--|----------------|
| Gross advertising income   | \$20,000       |
| Less: Direct advertising costs                                   | <u>5,000</u>   |
| Advertising gain   | \$15,000       |
| Less: Readership costs   | \$25,000       |
| Circulation income   | <u>19,200</u>  |
| Excess of readership costs<br>over circulation income            | <u>5,800</u>   |
| Unrelated business income attributable<br>to sale of advertising | <u>\$9,200</u> |

The organization determined its circulation income by multiplying its membership dues by a fraction whose numerator was periodical costs and whose denominator was such costs plus the other exempt activity costs.

|             |   |            |   |                                 |
|-------------|---|------------|---|---------------------------------|
| Circulation | = | Membership | X | <u>Periodical Costs</u>         |
| Income      |   | Dues       |   | <u>Periodical Costs + Other</u> |
|             |   |            |   | Exempt Activity Costs           |
| \$19,200    | = | \$64,000   | X | <u>\$30,000.000</u>             |
|             |   |            |   | \$30,000 + \$70,000             |

LAW

Section 511 of the Code imposes a tax upon the unrelated business taxable income of certain tax-exempt organizations, including those described in section 501(c)(3).

Section 512(a) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business.

Section 1.512(a)-1(f)(2)(ii) of the regulations provides that if the gross advertising income of a periodical exceeds the direct advertising costs, the costs attributable to the readership content of the periodical shall qualify as deduction directly connected with unrelated advertising activity, but only to the extent that such costs exceed the circulation income of the periodical and do not result in a loss from the advertising activity.

Section 1.512(a)-1(f)(3)(iii) of the regulations provides that where the right to receive an exempt organization periodical is associated with membership in such organization for which dues, fees, or other charges are received (hereinafter referred to as "membership receipts"), the circulation income of the periodical includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as "allocable membership receipts"). Allocable membership receipts is the amount which would have been charged and paid if (a) the periodical was that of a taxable organization, (b) the periodical was published for profit, and (c) the member was an unrelated party dealing with the taxable organization at arm's length.

Section 1.512(a)-1(f)(4) of the regulations provides that allocable membership receipts of a periodical shall be determined in accordance with the rules in section 1.512(a)-1(f)(4)(iii) where sections 1.512(a)-1(f)(4)(i) and (ii) do not apply. Sections 1.512(a)-1(f)(4)(i) and (ii) apply only where 20 percent or more of the periodical's circulation consists of sales to nonmembers or where membership dues from 20 percent or more of the members are less than those from other members because such members do not receive the periodical.

Section 1.512(a)-1(f)(4)(iii) of the regulations describes the pro rata method of allocating membership receipts to

circulation income. It provides that, since it may generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities (including the periodical) of the organization, the share of membership receipts allocated to the periodical shall be an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization. For example, under this method if an exempt organization has membership receipts of \$60,000, total periodical costs of \$30,000, and other exempt costs of \$70,000, then \$18,000 ( $\$60,000 \times \$30,000 / \$100,000$ ) of the membership receipts is allocated to the periodical's circulation income.

#### ANALYSIS

In this case, neither 20 percent of the total circulation of the periodical is sold to non-members nor are the membership dues of 20 percent of the members reduced because they do not receive the publication. The pro rata allocation of membership receipts under section 1.512(a)-1(f)(4)(iii) of the regulations must, therefore, be applied.

In applying the formula given in section 1.512(a)-1(f)(4)(iii) of the regulations, the phrase "cost of other activities" means the total costs or expenses incurred by an organization in connection with its other exempt activities, not offset by any income earned by the organization from such activities. See *Silverstein v. United States*, 349 F.Supp. 527, 530 (E.D.La.1972); 2 APB Accounting Principles, Accounting Terminology Bulletin No. 4,9523 (July, 1957). Thus, here, the organization's "cost of other exempt activities" was \$70,000.

#### HOLDING

Under the circumstances described above, the organization's method of allocating membership receipts to circulation income pursuant to the formula set forth in section 1.512(a)-1(f)(4)(iii) of the regulations is proper.