

Area Director, Office of Appeals, Field Operations East, Area 4
Philadelphia, PA

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's ID Number:

Years Involved:

Conference Held:

LEGEND:

M =

ISSUE:

Is M's sale of life insurance policies to the non-member widows of deceased insured members within a year following the member's death – policies under which the widow can name as a beneficiary someone other than a dependent of the member – substantially related (within the meaning of section 513 of the Internal Revenue Code (the "Code")) to the exercise or performance by M of any purpose or function described in section 501(c)(8)?

FACTS:

M is the parent entity of a fraternal beneficiary society that operates under the lodge system. Membership in M is limited to men of a particular faith. Under a group ruling issued by the Internal Revenue Service, M and its subordinate chapters are recognized as exempt from federal income tax under section 501(a) of the Code by reason of being an organization described in section 501(c)(8). Among the purposes (enumerated in M's corporate charter) for which M was formed are the purposes "of rendering pecuniary aid to its members, their families, and beneficiaries of members and their families [and] of rendering mutual aid and assistance to its sick, disabled, and needy members and their families."

M operates as an insurance company and contracts with full-time insurance sales persons to sell life insurance, annuities, and related products to its members. M sells individual life insurance contracts to members that may include separate coverage for the member's spouse or dependents. Such contracts also provide the insured's spouse the right, after the insured's death, to request insurance coverage on her life and on the lives of the insured's minor children. The right must be exercised within one year following M's receipt of proof of the insured's death.

Specifically, insurance contracts issued to members include the following provision or endorsement:

Spouses Right to Apply for Insurance

In addition to the other rights and benefits provided under this contract, after the Insured's death the Insured's spouse shall have the right to request insurance coverage: (1) on her life; and (2) on the lives of the Insured's minor children. This right must be

exercised within one year following the Order's receipt of proof of the Insured's death. The insurance coverage requested will be issued, provided that satisfactory evidence of insurability is submitted to the Order. The date the insurance coverage takes effect will depend upon: (1) the rules of the Order; and (2) the date the Order accepts the evidence of insurability.

For purposes of this provision, the following definitions apply: "insurance coverage" includes all plans of life insurance, annuities, and long term care insurance offered by the Order at the age and premium class of the proposed insured or annuitant at the time of the exercise of this right. "Insured's minor children" includes all children, stepchildren, and legally adopted children of the Insured who have not yet reached their 18th birthday as of the date insurance coverage is requested; and "Insured's spouse" means the person to whom the Insured is married as of the date of the Insured's death.

The widow's right to purchase insurance within one year of her husband's death is available only to a spouse whose husband was insured by M at the time of his death. If the member was not insured by M at the time of his death, the widow may not purchase insurance from M.

The widow may apply for coverage in a different amount, or of a different type, than that previously held by the member. A widow must meet normal underwriting requirements and criteria for the policy and amount she requests, and the insurance products that the widow is entitled to purchase are virtually indistinguishable, both in features and in price, from the insurance sold by taxable insurance providers.

M represents that the widow is under no obligation to name a dependent of the deceased member as a beneficiary of any insurance coverage she purchases and is entitled to change the beneficiary at any time, subject to any state law restrictions.

LAW:

Section 501(c)(8) of the Code exempts from federal income taxation fraternal beneficiary societies, orders or associations—(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association, or their dependents.

Section 1.501(c)(8)-1 of the Income Tax Regulations (the "regulations") provides that a fraternal beneficiary society is exempt from tax only if operated under the "lodge system" or for the exclusive benefit of the members so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident or other benefits.

Rev. Rul. 73-165, 1973-1 C.B. 224, holds that a fraternal beneficiary society which carries on fraternal activities, operates under a lodge system, and provides for member benefit payments may qualify for exemption under section 501(c)(8) of the Code. The ruling indicates that there is no requirement for exemption that either the fraternal features or the benefit features predominate as long as both features are present.

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

Section 512(a)(1) 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 the deductions allowed under Chapter 1 which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

In the case of an organization subject to the tax imposed by section 511, section 513(a) 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 the purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(a) of the regulations says that gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(d)(1) of the regulations says that gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question – the activities, that is, of producing or distributing the goods or performing the services involved – and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations says 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, 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. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of the organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

ANALYSIS:

A fraternal beneficiary society described in section 501(c)(8) of the Code is one "operating under the lodge system" and "providing for the payment of life, sick, accident or other benefits to the members of such society, order, or association or their dependents." Since the Code does not define a "fraternal beneficiary society," we presume that Congress used the term in the ordinary sense, and according to its legal significance, at the time that fraternal beneficiary societies were first exempted from federal income taxation under section 38 of the Tariff Act of August 5, 1909, 36 Stat. 113 (1909). See United States v. Cambridge Loan & Bldg. Co., 278 U.S. 55, 58 (1923) ("When Congress exempted [building and loan] associations from the income tax of course it was speaking of existing societies that commonly were known as such, not of ideals that would have been hard to find"); Commercial Travelers' Life & Accident Ass'n v. Rodway, 235 F. 370, 374 (N.D. Ohio 1913) ("The court shall assume that Congress used the term [fraternal beneficiary association] according to its legal significance at the time the act [of 1909] was passed.") (citation omitted). The term "fraternal beneficiary society" (or association or order) was extensively defined, judicially and by state statute, in the early twentieth century. Although most of the

authorities containing these definitions do not directly address section 501(c)(8) (or its predecessors), they have legal significance when interpreting the term "fraternal beneficiary society" and the phrase "providing for the payment of life, sick, accident and other benefits to the members of such society, order, or association or their dependents" contained in section 501(c)(8).¹

The most thorough judicial "definition" of the term "fraternal beneficiary association" can be found in Nat'l Union v. Marlow, 74 F. 775, 778-79 (8th Cir. 1896), where the court said:

We must accordingly assume that the words "fraternal-beneficial" were used in their ordinary sense, -- to designate an association or society that is engaged in some work that is of a fraternal or beneficial character. According to this view, a fraternal-beneficial society ... would be one whose members have adopted the same, or a very similar, calling, avocation, or profession, or who are working in unison to accomplish some worthy object, and who for that reason have banded themselves together as an association or society to aid and assist one another, and to promote the common cause.... As a general rule such associations have been formed for the purpose of promoting the social, moral, and intellectual welfare of the members of such associations, and their families, as well as for advancing their interests in other ways and in other respects.... Many of these associations make a practice of assisting their sick and disabled members, and of extending substantial aid to the families of deceased members.

In Commercial Travelers' Life & Accident Ass'n, 235 F. at 374, a federal court applied this definition of "fraternal beneficiary society" contained in Nat'l Union v. Marlow to conclude that a mutual protective association was not exempt from federal income taxation under the predecessor of section 501(c)(8).

As originally conceived, then, fraternal beneficiary societies existed principally to foster the communion and cooperation of their members for their mutual aid and benefit. In furtherance of that confraternity, the members took it upon themselves to contribute jointly and uniformly in the aid of their sick members and the families of deceased members. An early treatise on fraternal insurance summarized the ideal of fraternalism as follows:

Therefore, let it be understood that the American fraternal system had its beginnings as a result of the fraternal desire of men to cooperate for their mutual welfare and happiness, and that the benefit plan they introduced followed an innate prompting to protect their dependents.

See Walter Basye, History and Operation of Fraternal Insurance 39 (1919).

The first fraternal benefit funds were simple, equal assessments against all the members of the society:

[T]he benefit fund under the plan of the first society consisted of a single assessment and the money remained in the hands of the subordinate lodge recorders until demanded by the grand lodge for the purpose of paying a death claim. Each death exhausted the fund, but it was renewed by another assessment. Each member, upon an assessment call being made, without distinction on account of age or length of membership, paid an equal amount -- one dollar.

Id. at 56.

¹ This memorandum does not specifically address the definition or limits of the term "dependent" for purposes of section 501(c)(8), as setting the limits of that term is not necessary to address the issue raised.

It was the distinctiveness of the early fraternal benefit funds that provided a justification for the treatment accorded fraternal beneficiary societies under federal and state law. In addition to exemption from federal income taxation, fraternal beneficiary societies have commonly been exempted from the operation of the general insurance laws of the states and from state taxes except property taxes, as is the case under the laws of the state from which M received its charter. And courts have found that the feature that most distinguishes fraternal benefit plans from commercial insurance is that the fraternal plans are an expression of the fraternal ties between the members and not a commercial undertaking between insurer and insured. Thus, in Peterson v. Manhattan Life Ins. Co., 91 N.E. 466, 469 (Ill. 1910), the court said the following regarding how fraternal beneficiary societies were distinguishable from commercial insurance companies at the time the former were first exempted from federal income taxation:

In the ordinary sense a fraternal order is not an insurance company.... [T]he two classes of corporations are organized under different acts and for different purposes. A life insurance policy may be obtained either by the insured or any one having an interest in his life, may be payable to his estate, to a creditor, or to a beneficiary named.... The certificate of a beneficiary society may be obtained only by the member. It cannot be payable to his estate, but only to his widow or children or some one belonging to the classes mentioned in the statute....

Again, in Van de Water v. Order of United Commercial Travelers of America, 77 F.2d 331, 332 (2d Cir. 1935), the Court said:

Like mutual insurance companies, beneficial associations, doing business without capital on the assessment plan, differ from companies dealing in insurance only. The point of distinction lies in their organization. They are formed, usually, not as insurance companies but as social and benevolent associations; the insurance being but an incident, and not their main purpose. The insurance feature is conducted not for the purpose of gain, but for the object of benevolence.... The benefits are usually confined to limited classes of persons, one not a member of the society being unable, as a rule, to obtain a certificate of insurance, and the member's right to nominate the person to whom death benefits shall be paid, is usually limited either by statute, article, or by by-law.... Usually, the society and its members, by their elected representatives, are both the insurer and the insured, and the members have the right, through their representatives, to make or change their contract of membership or insurance. The insurance feature of such a fraternal society is exactly what its members, through their representative form of government, provide.

The idea that fraternal insurance derives its uniqueness from the fraternal bonds of the members was expounded by the Supreme Court of Missouri, in Biggs v. Modern Woodmen of America, 82 S.W.2d 898, 904 (Mo. 1935):

Fraternal benefit associations are essentially different in many respects from insurance companies.... They confine their operations to their own members. They do not solicit business from the general public.... They usually limit the class of persons who may be designated as beneficiaries to certain relatives of members. They do not operate for profit, but accumulate a fund from contributions of members to be used in the aid or relief of members or their beneficiaries.... The members are, in effect, both insurers and insured. The rights of the members or their beneficiaries to participate in the fund are not fixed by the terms of the certificate, as in the case of an ordinary life insurance policy, but depend also upon the constitution and by-laws of the association. Since they are self governing bodies, regulations are made by the members themselves through their duly elected representatives and, therefore, there is good reason to regard them in a somewhat different light from conditions written in a policy of insurance by an ordinary insurance company dealing with the general public for profit.... Recognizing such

differences, our Legislature has enacted a statute that such societies "shall be exempt from all provisions of the insurance laws of this state, not only in governmental relations with the state, but for every other purpose, and no law hereafter enacted shall apply to them, unless they be expressly designated therein...."

The courts recognized that because state law at the time fraternal beneficiary societies were first exempted from federal income taxation did not impose on these societies "the heavy duties and restrictions" that were imposed on old-line companies, it was lawful and proper for the state "to [admit] these societies into the arena of life insurance" only to the extent of "mak[ing] provisions for the payment of benefits in case of death of its members" from funds "derived from assessments or dues collected from its members." See State ex rel. Supreme Lodge K. P. v. Vandiver, 111 S.W. 911, 912-13 (Mo. 1908).

Accordingly, a primary distinction between the "payment of life, sick, accident, or other benefits to the members of [a fraternal beneficiary society] or their dependents" and insurance sold by taxable insurance firms lies in the nature of the membership rights in a fraternal beneficiary society. The sale of insurance to a member is part of the "mutuality of interest" that exists between the members of such societies. On the other hand, the sale of insurance to a non-member is nothing more than a mere contractual relationship between a policyholder and an insurance company. In Order of United Commercial Travelers of America v. Wolfe, 331 U.S. 586, 605-06 (1947), the Supreme Court said:

The relationship ... between a member and his fraternal benefit society differs from the ordinary contractual relationship between a policyholder and a separately owned corporate or "stock" insurance company. It differs also from that between an insured member of the usual business form of a mutual insurance company and that company. The fact of membership in the ... fraternal benefit society is the controlling and central feature of the relationship.

As an organization described in section 501(c) of the Code, M is subject to the tax imposed under section 511 on its unrelated business taxable income. Section 512(a)(1) tells us that "unrelated business taxable income" is income from an unrelated trade or business regularly carried on. Furthermore, section 1.513-1(a) of the regulations tells us that gross income is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such business is regularly carried on; and (3) the conduct of such trade or business is not substantially related to the organization's exempt purposes.

M derives income from frequent and regular sales of insurance contracts to the widows of deceased members. The sale of insurance is a trade or business and, in the case of M, such sales are regularly carried on. Thus, unless such sales are substantially related to M's performance of its exempt fraternal functions, the revenue derived from those sales is includible in M's unrelated business taxable income. To determine whether such sales constitute an unrelated trade or business, section 1.513-1(d)(1) of the regulations tells us to examine the relationship between those sales and the accomplishment of M's fraternal purposes. If it is found that such sales do not contribute importantly to M's exempt fraternal purposes, section 1.513-1(d)(2) tells us that those sales are not substantially related to exempt purposes and are, therefore, "unrelated trade or business" within the meaning of section 513 of the Code.

Any sale of insurance that is inconsistent with the historical meaning of the term "fraternal beneficiary society" and the section 501(c)(8) phrase "*providing for the payment of life, sick, accident and other benefits to the members of such society, order, or association or their dependents*" is not substantially related to M's exempt purposes described in section 501(c)(8) (emphasis added). See Ocean Pines Ass'n, Inc. v. Comm'r, 135 T.C. 276, 283 (2010), *aff'd* 672 F.3d 284 (4th Cir. 2012) ("Logically, if . . . activities do not contribute to . . . [an organization's tax-exempt purpose] in the context of determining whether an organization qualifies for exemption,

then surely these same activities cannot be said to be related to the organization's exempt purpose in the context of the UBTI provisions.") (*quoting Prof'l. Ins. Agents of Mich. v. Comm'r*, 78 T.C. 246, 267 (1982), *aff'd* 726 F.2d 1097 (6th Cir. 1984)).

M is organized for the exempt fraternal purpose of rendering pecuniary and mutual aid and assistance to its members and their dependents.² Membership in M is limited to men. The insurance contracts that M enters into with its members gives the member-insured's spouse, upon the death of the member-insured, the right to request insurance coverage on her own life or the lives of the member-insured's minor children, which insurance can provide benefits to individuals who are not dependents of the member. The member-insured's spouse is ineligible for membership in M, and thus lacks any fraternal relationship or mutuality of interest with the members of M. The insurance coverage that is offered to the widow after the member's death is no mere continuation of the member's policy. The widow may apply for coverage in a different amount, or of a different type, than that previously held by the member. The widow is not guaranteed coverage, but must satisfy M's usual underwriting criteria before a policy will be issued to her. Further, the insurance products that the widow is entitled to purchase are virtually indistinguishable, both in features and in price, from the insurance sold by taxable insurance providers. Consequently, the sale of insurance to the widow is no different than an ordinary contractual relationship between a policyholder and an insurance company.

Importantly, among the requirements for exemption under section 501(c)(8) is the requirement that a fraternal beneficiary society provide for the payment of "life, sick, accident, or other *benefits*" (emphasis added) to the members of the society *or their dependents*. Thus, the sale of an insurance policy by a fraternal beneficiary society cannot be said to contribute importantly to such society's exempt fraternal purpose to the extent that anyone other than a member of the society or a dependent of the member is named as a beneficiary of the policy.

If M allows the widow of a deceased member to purchase life insurance on her own life, the proceeds of the policy would be payable, on the widow's own death, to beneficiaries selected by the widow. Though the widow might name a dependent of the deceased member as the beneficiary of the policy, she is under no obligation to do so, and she is entitled to change the beneficiary at any time. Thus, the widow could name as a beneficiary, someone who was not a member or dependent of a member of the fraternal benefit society. For example, if the widow were to remarry after the member's death, she could name her new spouse or any children of the new spouse, as beneficiaries of her insurance policy, none of whom could be considered "dependents" of the member at the time of his death.

Consequently, M's sales of insurance contracts to the widows of deceased members have none of the characteristics that courts have said make fraternal insurance distinguishable from commercial insurance so as to justify exemption from taxation. Such contracts are not benefits payable to the widow on the death of the member. *Compare State ex rel. Supreme Lodge K. P. v. Vandiver*, above. Instead, such insurance contracts are obtainable by persons other than members, are paid for by persons other than members, and are payable to persons who were never nominated by the member and who may not even have been dependents of the member. *Compare Peterson v. Manhattan Life Ins. Co.* and *Van de Water v. Order of United Commercial Travelers of America*, above. Furthermore, by selling insurance contracts to the widows of deceased members, M does not confine its insurance operations to its own members. Rather, it enters into purely commercial arrangements with insureds whose rights are fixed by the terms of the insurance policy and not dependent, by membership, on the constitution and by-laws of the society. *Compare Biggs v. Modern Woodmen of America*, above. And because the insurance contracts offered to widows are substantially similar in features and price to insurance contracts offered by large mutual life insurance companies, such sales are not conducted "for the object of

² Although M's corporate charter uses the term "families," section 501(c)(8) describes providing for the payment of benefits to "dependents." Consistent with the Code section constituting the basis for M's exemption, we use the term "dependents" in describing M's exempt purpose.

benevolence," but appear to be conducted "for the purpose of gain" (see Van de Water v. Order of United Commercial Travelers of America).

Since there is nothing in M's sale of insurance contracts to the widow of a deceased member to distinguish the relationship that exists between the widow and M from an ordinary contractual relationship between a policyholder and a corporate insurance company (*compare* Order of United Commercial Travelers of America v. Wolfe, above), and since the widow would be able to name as a beneficiary of her policy someone other than a dependent of the member, such sales do not contribute importantly to M's exempt fraternal purpose of rendering pecuniary aid to its members and their dependents and thus are not substantially related (other than through the production of funds) to M's exempt fraternal purposes. Therefore, M's sales of commercial-type insurance to non-members constitutes an unrelated trade or business.

CONCLUSION:

M's sale of life insurance policies to the non-member widows of deceased insured members within a year following the member's death – policies under which the widow can name as a beneficiary someone other than a dependent of the member – is not substantially related (within the meaning of section 513 of the Internal Revenue Code (the "Code")) to the exercise or performance by M of any purpose or function described in section 501(c)(8).