H. NONMEMBER INCOME OF SOCIAL, FRATERNAL, VETERANS, AND SOCIAL WELFARE ORGANIZATIONS

1. Scope of Discussion

There are many types of membership organizations that are social in nature and whose nonmember activities give rise to a continuing host of problems. The purpose of this article is to explore some of those problems.

2. Introduction

However people gather together in a membership organizational setting, three constants exist: the need to socialize; the need for refreshment; and the need for entertainment. These needs manifest themselves through the organization's activities, which often include gambling and the operation of a bar, restaurant, and meeting hall. While it may be argued generally that members engaged in these activities are actually conducting activities that are in furtherance of the exempt purposes of the organization, a different result occurs when there is a nonmember element.

The nonmember element is often a necessity. Without outsiders, social, fraternal, and veterans' organizations often find themselves without the wherewithal to carry out their exempt activities. Thus, at least some portion of the activities of these organizations involve fund-raising efforts. Further, some membership organizations, in addition to renting facilities, operating a bar, or catering social events, raise income through gambling activities, direct mail solicitations, and the exchange of mailing lists.

Problems arise not only in the area of unrelated trade or business, but more fundamentally with the basis for the exemption of these membership organizations.

3. Social Clubs - IRC 501(c)(7)

Social clubs are the most obvious form of membership organization. The operation of a bar, restaurant, and meeting hall are all considered to be appropriate activities for a social club in providing pleasure and recreation to its membership. In addition, the Service has maintained for some time the position that the operation of gaming devices, and gambling generally, in social clubs open only to members and their guests is an appropriate exempt activity under IRC 501(c)(7) because it supplies an element of diversion commonly accepted as pleasure or recreation,

notwithstanding the fact that an additional purpose may be to raise funds for the continued operation of the club. See: Rev. Rul. 69-68, 1969-1 C.B. 153.

Social clubs are exempt from taxation under IRC 501(c)(7) if organized for the pleasure and recreation of the membership, and for other nonprofitable purposes, and if substantially all of the activities of the club are for such purposes with no part of the net earnings of the club inuring to the benefit of any private shareholder. The definition, therefore, allows some nonmember income. Congress has, in the legislative history underlying the most recent change in the wording of IRC 501(c)(7), indicated, as a safe haven, that receipts from nonmembers are permissible so long as they do not exceed 15% of total receipts or, if they do, a facts and circumstances test is met. (H. Rep. No. 94-1353, 94th Cong., 2d sess. (1976), at p. 4, and S. Rep. No. 94-1318, 94th Cong., 2d Sess. (1976), also at p. 4).

A recurring question in the area is what tax effect does income derived from the general public have upon the organization. Certain presumptions exist in the social club area with regard to regular and recurring use of club facilities by nonmembers. These presumptions are found in Rev. Proc. 71-17, 1971-1 C.B. 683.

Extensive use of club facilities by nonmembers, may, of course, be grounds for loss of tax exempt status. Where the use is not extensive, exemption is not affected but such use may give rise to unrelated business taxable income. The procedures in Rev. Proc. 71-17, if followed, allow the social club to avoid having the income from such activities be labelled as from "substantial non-exempt use" and allow income derived from use of the club facilities by nonmember guests to be treated as if wholly from members, that is, as exempt function income and not unrelated trade or business income.

The guidelines require extensive recordkeeping to substantiate audit assumptions. In two instances it is assumed that the nonmembers present at a function are guests of members: (1) where payment for the function is received from the member or the member's employer as payment for a party consisting of no more than eight persons, at least one of whom is a member, and (2) where 75-percent of those present at the club function are members, and payment for the function is received directly from one or more members or a member's employer. Solely for the purposes of the above two guidelines, payments received from a member's employer will be deemed to be for a use that serves the direct business of the employee-member. In these instances, the income in question is considered as received from a member. In all other cases, the host-guest relationship will not be assumed. To avail itself of the audit assumption that the nonmember use is not substantial, extensive recordkeeping

is required including: date; total number in party; number of nonmembers in party; total charges; charges attributable to nonmembers; charges paid by nonmembers; whether members paying have been or will be reimbursed by nonmembers; where there is employer reimbursement, full particulars of the business relationship; and, finally, a statement, if applicable, that the amount paid by the non-member was paid gratuitously for the benefit of a member.

Social clubs are subject to special rules with regard to the treatment of income derived from nonmembers. IRC 512(a)(3) provides that all income, other than "exempt function income," is subject to the tax on unrelated trade or business. IRC 512(a)(3)(B) provides that the term "exempt function income" means the gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests, goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

Income derived from nonmembers who are not "guests," therefore, does not fall within the exception of "exempt function" income and thus is taxable as unrelated business income.

4. Fraternal Organizations - IRC 501(c)(8) and (10)

a. Exemption Issues

IRC 501(c)(8) exempts fraternal beneficiary societies, orders, or associations, which: (A) operate under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and (B) provide for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

IRC 501(c)(10) exempts domestic fraternal societies, orders, or associations, operating under the lodge system: (A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and (B) which do not provide for the payment of life, sick, accident, or other benefits.

The Code does not define the terms contained in either of these exemption provisions. The meaning of fraternal and what constitutes a fraternal activity is left to the common understanding and usage of the term.

The definition of fraternal beneficiary association generally accepted by commentators is found in the case of National Union v. Marlow, 74 F. 775, (8th Cir. 1896):

> "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 and 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. The term fraternal can properly be applied to such an association, for the reason that the pursuit of a common object, calling or profession usually has a tendency to create a brotherly feeling among those who are thus engaged. It is a well-known fact that there are at the present time many voluntary or incorporated societies which are made up exclusively of persons who are engaged in the same avocation. 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. Their work is at the same time of a beneficial and fraternal character, because they aim to improve the condition of a class of persons who are engaged in a common pursuit, and to unite them by a stronger bond of sympathy and interest. ..."

Despite the apparent breadth of this definition, the exemption provision itself has been narrowly construed when dealing with regular fraternal activities in which nonmembers can potentially participate.

A recent case provides an object lesson to membership organizations that exceed the bounds of a particular exemption category. The case is Knights of Columbus Building Association of Stamford, Conn., Inc. v. United States, 61 AFTR2d 88-1212 (DC Conn. 1988). The organization in question sought a refund of taxes paid on the grounds that it was exempt under IRC 501(c)(2), (3), (4), (7), (8), or (10), and because it was the adjunct of the Knights of Columbus Council, which had been recognized as exempt under IRC 501(c)(8). The Association was a corporation that held title to the council's property and operated a bar and buffet in a building that contained offices, meeting rooms, a meeting hall, a recreation area, a kitchen, and a lounge. While the extent of nonmember involvement was not clear, it was indicated in the case that these facilities were utilized by nonmember community organizations, other than the parent Knights of Columbus council. The Association was denied status under IRC 501(c)(8) on the grounds that it was not operating within the

exemption provision of its parent council and the adjunct theory was inapplicable to the organization. With regard to the adjunct theory, the court rejected the idea that the theory could be used to erode the differentiations inherent in the various exemption provisions, which, the court found, must be strictly construed. Exemption therefore was also denied under all other claimed IRC 501(c) paragraphs. There is support for this position in Rev. Rul. 81-117, 1981-1 C.B. 346.

If there is little guidance in the area of what constitutes a fraternal organization, there is less yet as to what constitutes a fraternal activity. Nonetheless, over time certain types of activities have come to be accepted as normal activities for a fraternal organization.

Social and recreational activities have traditionally been considered a type of activity in which fraternal organizations engage along with other purely fraternal activities. The operation of a bar, restaurant, or general meeting hall by fraternal organizations is thus easily placed within a social and recreational context. In addition, gambling activities to the extent of fraternal members' participation usually has a substantial causal relationship to the exempt purposes of such organizations because such activities are also recreational in nature. Consequently, these activities are appropriate for fraternal associations exempt under IRC 501(c)(8) or IRC 501(c)(10), and when limited to members do not give rise to problems with regard to exemption.

In many localities, the bar, restaurant, and meeting hall operation of the local lodge of a fraternity may be the only "public" gathering place available. Therefore, it can be expected that substantial numbers of nonmembers may avail themselves of the lodge's facilities. In addition, many lodges make it a customary practice to open up some social activities of the lodge to members of the general public.

When nonmembers are solicited by the fraternal organization to engage in these activities, there is the potential for the fraternal organization exceeding the bounds of the exemption provision. This is especially the case where the activity is of a continuous or recurring nature, such as the operation of a bar and restaurant, supposedly for member use, which over time has been opened to, or is generally known to be available to, the general public. When this happens it becomes a regular commercial business.

b. Unrelated Business Income Issues and IRC 513(f)

In the context of income-generating activities, the question which must be asked is: What types of activities conducted primarily for the members, but also open to nonmembers, give rise to nonmember income? Gambling activities are a typical vehicle for fund-raising for fraternal organizations.

Recreational gambling provided to guests of members is only related to the organization's exempt function if the cost of the entertainment of the guests is borne by the members rather than the guests. If, in a particular case, the gambling expenses of a guest are borne by a member, the gambling activity of that guest can be considered substantially related to the organization's exempt function. This scenario is highly unlikely, given the needs of most fraternal organizations for funds to finance operations.

Although, under certain circumstances, making the organization's recreational facilities and social activities available for members to entertain their guests may be considered part of providing social and recreational activities to members and in this sense further exempt fraternal purposes, a nonmember merely being accompanied by a member does not mean that that individual is being entertained by a member. When nonmember "guests" spend their own funds to participate in gambling activities operated by these organizations, they are not being entertained by the members. A guest is only being entertained by a member at a social or recreational activity or facility of the organization for which there is a charge for such participation in the activity or use by the guest if the member pays that charge. When guests gamble with their own money, the fraternal organizations are providing recreational activities in the form of gambling directly to nonmembers rather than as a service to members. Providing recreational activities such as gambling to nonmembers directly rather than as a service to members does not have a substantial causal relationship to the exempt purpose of providing social and recreational activities to the member and may as a result be considered unrelated trade or business.

IRC 513(f) effectively removes the game of bingo (as it is commonly known and played) from the definition of unrelated trade or business provided that the game is not otherwise carried on within a particular state on a commercial basis and the conduct of the game itself does not violate any State or local law. The removal of bingo from the definition of unrelated trade or business may be a tribute to the game's universal popularity.

The standards on when the IRC 513(f) exception applies have been the source of much confusion among the members of the general public, probably because of the manner in which the exception was enacted. In order to end this confusion, the

Service has published Announcement 89-138, 1989-45 I.R.B. 41, which is reproduced below:

TAXATION OF GAMBLING ACTIVITIES CONDUCTED BY TAX EXEMPT ORGANIZATIONS

ANNOUNCEMENT 89-138

Purpose

The purpose of this Announcement is to remind tax exempt organizations that income from the public conduct of bingo and other gambling activities may be subject to the unrelated business income tax imposed by section 511(a) of the Internal Revenue Code. Over the years, changes to the unrelated business income tax provisions applicable to bingo and other gambling activities have created confusion for tax exempt organizations. This Announcement will recap the rules applicable in this area.

Background

Frequently, tax exempt organizations have been involved in conducting bingo and other games of chance such as pull tabs, raffles, video games, poker, 21, punch board, and lotteries for the public. Conduct of these games has been a means of raising funds to carry on their exempt activities. The organizations that have, historically, engaged in these activities include: charities described in section 501(c)(3) of the Code; social welfare organizations described in section 501(c)(4); recreational organizations described in section 501(c)(7); fraternal organizations described in section 501(c)(8) or (10); and, veterans organizations described in section 501(c)(19).

With more and more tax exempt organizations getting involved in this industry, the Service is concerned with the level of the noncompliance of some organizations with the unrelated business income tax provisions and will be reviewing the gambling activities of tax exempt organizations as part of its Special Emphasis Program on Fund-Raising Activities.

Unrelated Business Income Tax Provisions Governing The Public Conduct Of Bingo And Gambling Activities

Prior to 1976, the income of a number of tax exempt organizations from the public conduct of gambling activities (including bingo) was subject to unrelated business income tax. See Rev. Rul. 68-505, 1968-2 C.B. 248, which holds a county fair association that is exempt under section 501(c)(3) subject to unrelated trade or business tax on income from parimutuel betting conducted in connection with its two-week race meeting. See also Smith-Dodd Businessman's Assn. Inc. 65 TC 620 (1975), holding a businessman's association, exempt under section 501(c)(4), subject to unrelated business income tax on proceeds from public bingo games.

In the Tax Reform Act of 1976, Congress enacted an exception under section 513(d)(1) of the Code for "public entertainment activity" described in section 513(d)(2) conducted in conjunction with public fairs or expositions. This exception, applicable to organizations described in section 501(c)(3), 501(c)(4), or 501(c)(5), covers:

(1) public entertainment activity conducted in conjunction with an international, national, State, regional, or local fair or exposition,

(2) activity conducted in accordance with State law which permits the activity to be conducted only by that type of exempt organization or by a governmental entity, or

(3) activity conducted in accordance with State law which allows that activity to be conducted for not more than 20 days in any year and which permits the organization to pay a lower percentage of the revenue to the State than is required from other organizations.

The legislative history of the Tax Reform Act of 1976 indicates that section 513(d) of the Code was meant to reverse Rev. Rul. 68-505.

In 1978, Congress enacted an exception from unrelated business income tax for income from certain bingo games. This exception was intended to apply to bingo games conducted for the public. The exception is contained in section 513(f) of the Code. The section 513(f) exception refers to bingo games that are not normally conducted on a commercial basis if the conduct of the games is not in violation of state or local law. At the same time, Congress also provided that the bingo income of section 527 political organizations, that met the requirements of section 513(f)(2), would be treated as "exempt function" income for purposes of section 527(e)(1).

In section 311 of the Deficit Reduction Act of 1984, Congress enacted yet another exception that applied to games of chance other than bingo. This exception involved games of chance conducted after June 30, 1981. It applied in situations where as of October 5, 1983, there was a state law in effect that permitted the conduct of games of chance only by a nonprofit organization.

Two amendments to section 311 followed in the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), that ultimately limited the exception to games of chance conducted by nonprofit organizations in the state of North Dakota.

The net effect of the legislation from 1984-1988 is to exempt from tax income from games of chance (other than bingo) conducted in North Dakota after June 30, 1981, that do not violate state or local law. From June 30, 1981, through October 22, 1986, games of chance (other than bingo) conducted outside of the state of North Dakota are not subject to unrelated business income tax as long as state law was in effect, on October 5, 1983, that permitted the conduct of games of chance only by a nonprofit organization. These rules are applicable to games of chance conducted for the public. As indicated above, the treatment of proceeds from bingo under the unrelated business income tax provisions is governed by section 513(f) of the Code.

In summary, therefore, although section 513(f) of the Code exempts the income from certain bingo games legally conducted by exempt organizations from taxation as unrelated trade or business income, income from other gambling activities conducted by exempt organizations outside of North Dakota after October 22, 1986, is generally treated as unrelated business income unless it meets one of the other exceptions of section 513, such as where substantially all the work in carrying on the activity is performed by volunteers under section 513(a)(1).

Further Information

For further information regarding this announcement, contact Karen B. Carroll of the Employee Plans and Exempt Organizations Operations Division on (202) 566-6181 (not a toll-free call).

From this announcement, it is clear that the exception of IRC 513(f) is now narrowly drawn and does not include games of chance other than bingo.

One of the more common forms of fund-raising for the fraternal organization is hall rental and catering incident thereto. The rental of the hall itself, while unrelated

trade or business if regularly carried on, ends up not being taxed because of the exception for rents set forth in IRC 512(b)(3). The addition of catering, that is, the addition of bar and food service, results in at least the portion of income related to the provision of these services being taxable under the unrelated trade or business provisions, if volunteer labor is not employed in the provision of these services, and the catering is regularly carried on. The analysis set forth above with regard to gambling activities of fraternal organizations (other than bingo) and nonmember "guests" also applies in the areas of hall rental, bar and restaurant catering, and similar fund-raising activities.

5. Veterans' Organizations - IRC 501(c)(19)

a. Exemption Issues

Congress added IRC 501(c)(19) in 1972, and made it retroactive to 1970. In enacting IRC 501(c)(19), Congress acknowledged that previously veterans' organizations had been exempt under either IRC 501(c)(4) or IRC 501(c)(7). S. Rep. No. 92-1082, 92nd Cong. 2d Sess. 2 (1972). This report indicated that one of the activities of such organizations had been to provide insurance for their members and their dependents and that such activity might be considered unrelated trade or business for organizations exempt under either IRC 501(c)(4) or IRC 501(c)(7).

IRC 501(c)(19) provides that a post or organization of past or present members of the Armed Forces of the United States, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization qualifies for exemption if:

(A) organized in the United States or any of its possessions.

(B) at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, or widowers of past or present members of the Armed Forces of the United States or of cadets, and

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Reg. 1.501(c)(19)-1(c) requires that such a post or organization of war veterans claiming exemption under IRC 501(c)(19) must be operated exclusively for one or

more of the purposes listed in that section, one of which is to provide social and recreational activities for their members.

Care must be taken in this area, when nonmembers are admitted to veterans club facilities, that the bounds of the exemption provision are not inadvertently exceeded. While the provision of social and recreational facilities to members is an appropriate activity, providing such facilities to the general public is not.

b. Unrelated Business Income Issues, IRC 513(f) and IRC 513(h)

IRC 501(c)(19) provides that a post or organization of veterans shall be exempt from taxation. This, however, does not mean that all income from all possible organizational activities is exempt from taxation. IRC 511(a)(1) provides that a tax will be imposed upon the unrelated business income of an otherwise exempt organization. For this tax to be imposed, several criteria must be met. First, the income must result from a trade or business regularly carried on by the organization. In addition to being regularly carried on by the organization, the business must not be substantially related (aside from the needs of the organization for funds or income) to the exercise or performance of the function which is the basis of its exemption under IRC 501(c). Reg. 1.513-2(a). Finally, the income must not be subject to one of the special rules of IRC 512(a) or the modification (exclusions) set forth in IRC 512(b).

IRC 501(c)(19) veterans' organizations are subject to a special rule in IRC 512(a)(4). IRC 512(a)(4) provides that unrelated business income does not include any amount attributable to payments for life, sick, accident, or health insurance with regard to members of such organizations or their dependents that is set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in IRC 170(c)(4).

Reg. 1.512(a)-4 provides that, except for special rules regarding insurance set asides indicated in that section, veterans' organizations exempt under IRC 501(c)(19) are subject to the rules contained in IRC 511 through 514, regarding unrelated business income.

A problem arises under the unrelated business income tax provisions when nonmembers are allowed to use the facilities. The question of the treatment of nonmember income must ultimately be resolved by determining whether this income is unrelated to the exempt purposes of the organization.

An organization described in IRC 501(c)(19) carries out activities in furtherance of its exempt purposes when, and only when, the activities are carried out exclusively in furtherance of the purposes listed in Reg. 1.501(c)(19)-1(c). Among these purposes is the provision of social and recreational activities for its members. Reg. 1.501(c)(19)-1(c)(8). When a veterans' organization described in IRC 501(c)(19) provides social and recreational activities for its members, or for guests whose expenses are paid by members, it is engaged in activities in furtherance of its exempt purposes.

Although it is in furtherance of the exempt purposes of a veterans' organization described in IRC 501(c)(19) to provide social and recreational services to nonmembers who are being entertained by members, it is not in furtherance of exempt purposes when the nonmember pays for the services provided. The furnishing of these services is outside the scope of Reg. 1.501(c)(19)-1(c). A paying nonmember is a purchaser of the goods or services provided by the organization, and is a direct recipient of those goods or services from the organization. Such a nonmember is not considered to be entertained by a member but is instead considered to be a principal in a business transaction with the organization. The host-guest relationship is missing when the nonmember pays. In this case, the veterans' organization becomes subject to the tax imposed on unrelated business income.

As was the case with fraternal organizations, veterans' organizations can benefit from IRC 513(f), which removes bingo from the definition of unrelated trade or business, provided the game is not otherwise carried on within a particular state on a commercial basis and the conduct of the game itself does not violate any State or local law.

Two other forms of fund-raising common to veterans' organizations are the use of low-cost articles in fund-raising activities and the rental of mailing lists. By virtue of IRC 513(h) (which pertains only to IRC 501(c)(3) organizations and certain war veterans' organizations), these sources of nonmember income also have been removed from the definition of unrelated trade or business. Again, this may attest to the popularity of these fund-raising techniques.

6. Social Welfare Organizations - IRC 501(c)(4)

a. Exemption Issues

IRC 501(c)(4) exempts civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of

employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

Reg. 1.501(c)(4)-1 provides that an organization embraced within IRC 501(c)(4) is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. An organization is not operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members.

Many varied types of organizations qualify under IRC 501(c)(4). These organizations include: parent-teacher associations (Rev. Rul. 61-153, 1961-2 C.B. 114), junior chambers of commerce (Rev. Rul. 65-195, 1965-2 C.B. 164), community water companies (Rev. Rul. 66-148, 1966-1 C.B. 143), garden clubs (Rev. Rul. 66-179, 1966-1 C.B. 139), non-profit regional festivals (Rev. Rul. 68-224, 1968-1 C.B. 262), war veterans' organizations (Rev. Rul. 68-455, 1968-2 C.B. 215), amateur sports organizations (Rev. Rul. 69-384, 1969-2 C.B. 122, and Rev. Rul. 70-4, 1970-1 C.B. 126), volunteer fire companies (Rev. Rul. 74-361, 1974-2 C.B. 159), and consumer protection organizations (Rev. Rul. 78-50, 1978-1 C.B. 155), to name but a few.

By the varied nature of the exemption provision, it is clear that IRC 501(c)(4) organizations need not have members. Where the organization is a "membership" organization, initially its activities are scrutinized to determine whether the activities of the organization are actually the promotion of social welfare or in the alternative merely the provision of benefits to its members. Where the activities are primarily the provision of benefits to its membership, a further inquiry is made as to whether the membership is synonymous with the community at large such that the extension of particular benefits through the activities of the organization can be said to be the promotion of social welfare.

Social welfare organizations, like all exempt organizations, are in need of sources of financial support in order to carry out their exempt activities. Where the social welfare organization has a membership, activities conducted among such members which raise funds are examined to determine the relationship of the fund-raising activity to the exempt purposes of the organization.

The introduction of nonmembers into this fact pattern may affect exemption. Further, general recreational activities aside, the operation of a bar, restaurant, or meeting hall, or the conduct of gambling, for example, as recreational activities is

substantially at odds with the basic purpose for exemption. Extensive nonmember recreational activities will result in the organization being treated as a regular commercial business and not an exempt organization.

b. Unrelated Business Income Issues and IRC 513(f)

Rev. Rul. 66-150, 1966-1 C.B. 147, considers the exemption of a subsidiary of a veterans' organization described in IRC 501(c)(4). The subsidiary's primary purpose is to operate social facilities for members of the veterans' organization and their guests including a bar, restaurant, and game room. Rev. Rul. 66-150 holds that the subsidiary does not qualify as an organization described in IRC 501(c)(4). The rationale for the ruling is that the subsidiary engages in no social welfare activities and its primary activity is operating a social club.

One of a veterans' organization's stated purposes is to promote comradeship among its members. Although such a purpose, in conjunction with other purposes that promote the social welfare, may not preclude an organization from being described in IRC 501(c)(4), promotion of comradeship among members of a veterans' organization does not itself serve to bring about civic betterment and social improvement and thus does not constitute a basis for the exemption of the veterans' organization as an organization described in IRC 501(c)(4). This conclusion is implicit in the holding of Rev. Rul. 66-150.

Therefore, the sale of food and beverages does not contribute importantly to and, thus, does not have a substantial causal relationship to the exempt purposes of a veterans' organization described in IRC 501(c)(4). Consequently, the sale of food and beverages by an IRC 501(c)(4) organization is unrelated trade or business within the meaning of IRC 513 regardless of whether the sale is to members or nonmembers.

There is an extremely important differentiation between the volunteer fire company, which is exempt under IRC 501(c)(4), and the veterans' organization exempt under IRC 501(c)(4). The analysis in Rev. Rul. 74-361, 1974-2 C.B. 159, is inapplicable to a veterans' organization described in IRC 501(c)(4). Rev. Rul. 74-361 concludes that providing recreational activities to members of volunteer fire companies described in IRC 501(c)(4) furthers the exempt purposes of the organization. Members of volunteer fire companies have unique needs for recreation. The recreational activities in that ruling were found to promote the social welfare because the provision of such activities helps the members to better perform their exempt function of fighting fires in the community. This analysis is not applicable to the veterans' organization.

7. Conclusion

Nonmember income generated by IRC 501(c)(4), (7), (8), (10), and (19) organizations must be scrutinized closely to determine whether the activity giving rise to such income either adversely affects the organization's exempt status or subjects it to the unrelated trade or business tax provisions.

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1990 UPDATE
Editor's Note: In late 1990 the IRS updated each topic that came outin early 1990 in its Exempt Organizations Continuing Professional EducationTechnical Instruction Program textbook for 1990. As a result, what you have already read contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

H. NONMEMBER INCOME OF SOCIAL, FRATERNAL, VETERANS, AND SOCIAL WELFARE ORGANIZATIONS

1. Veteran's Organizations - IRC 501(c)(19)

Unrelated Business Income Issues, IRC 513(f) and IRC 513(h)

The IRC 513(h) exception to the definition of unrelated trade or business applies to organizations described in section 501 to whom contributions are deductible under IRC 170(c)(2) or (3). Otherwise, the business of the renting of mailing lists has been considered by the Service to be a trade or business and subject to the unrelated trade or business tax.

Current Service position on mailing list rentals derives from the 1981 Disabled American Veterans case. In Disabled American Veterans v. United States, 227 Ct. Cl. 474, 650 F. 2d 1178, 81-1 U.S.T.C. para. 9443 (Ct. Cl. 1981), hereafter (DAV I) the Court of Claims found that:

> "...section 512(b) excludes from taxation the conventional type of passive investment income traditionally earned by exempt

> organizations (dividends, interest, annuities, real property rents.) .... DAV's list rentals activity are the product of extensive business activity by DAV and do not fit within the types of "passive" income set forth in section 512(b)."

The Service has followed the holding of DAV I.

The unrelated business income tax status of the rental of mailing lists has recently been brought into question by a case handed down in the Tax Court entitled: Disabled American Veterans v. Commissioner, 94 T.C. 60 (1990) (hereafter DAV II).

In DAV II, the Disabled American Veterans (DAV) licensed the names on its donor list to other organizations, both tax-exempt and for profit, for one-time mailings. DAV conceded that its activity was a trade or business, regularly carried on, that was unrelated to its exempt purpose. Both parties stipulated that the mailing lists were an intangible asset. The court held the amounts DAV received from its activities were royalties which are excluded from unrelated business taxable income because of section 512(b)(2). The rationale for the ruling was a finding by the court that the use of the list was the use of an intangible asset, and that payment for licensing of use of an intangible asset was a royalty, notwithstanding the fact that DAV was actively involved in the business of marketing its mailing lists. Also relied upon by the Tax Court was Rev. Rul. 81-178, which the Tax Court believed represented a change in Service position.

Rev. Rul. 81-178, 1981-2 C.B. 135, did not change the active-passive distinction, of DAV I. As noted in the majority decision of DAV II, Rev. Rul. 81-178 provides that payments for certain types of intangible assets of the exempt organization, for example; trademarks, trade names, service marks, copyrights, member's names, photographs, likenesses, and facsimile signatures are royalties under section 512(b)(2). However, the revenue ruling further states that the active participation of members in making product endorsements removes the payments from the royalty exception.

Neither the Service, nor subsequent case law indicated any change in Service position based upon Rev. Rul. 81-178.

In Fraternal Order of Police v. Commissioner, 87 T.C. 747 (1986), at page 758, the advertising revenues (the listing receipts) were found not to be royalties within the contemplation of section 512(b)(2) because the petitioner's role in the publication of The Trooper was not passive. No indication was given by the Tax Court that Rev.

Rul. 81-178 had in any way changed the active-passive analysis required before a royalty was found to be includable within the definition of IRC 512(b)(2). The Seventh Circuit on appeal in Fraternal Order of Police v. Commissioner, 833 F.2d 717, 87-2 U.S.T.C. para. 9624 (7th Cir. 1987) found this analysis was still viable.

In National Well Water Association, Inc. v. Commissioner, No. 92 T.C. 75 (1989), the Tax Court again addressed the issue of royalties, this time in the context of insurance dividends. Assuming, arguendo, that these dividends were unrelated business taxable income, the Court focused upon whether the petitioner had an active or passive role. Because petitioner's duties with regard to this income consisted of administrative and advertising services for the insurance company, the court concluded that petitioner played an active role and the income derived was not royalty income.

Finally, in National Collegiate Athletic Association v. Commissioner (hereafter NCAA), 92 T.C. 456, 92 T.C. No. 27 (1989), the issue of what constituted a royalty was again discussed. The court stated:

> "Whether an item of income constitutes a royalty is to be determined from all of the facts and circumstances in each case. Sec. 1.512(b)-1, Income Tax Regs. Generally, a royalty is a payment for the use of a valuable right such as a trademark, trade name, service mark, or copyright, regardless of whether the property represented by the right is used. Fraternal Order of Police v. Commissioner, 87 T.C. 747, 757 (1986), affd. 833 F.2d 717 (1987). In Disabled American Veterans v. United States, 650 F.2d 1178, 1189 (Ct. Cl. 1981), the Court of Claims held that royalties also are payments "which constitute passive income, such as the compensation paid by a licensee to the licenser for the use of the licenser's patented invention." 650 F.2d at 1189."

In DAV II, the petitioner was actively involved in maintaining its list as a viable commercial commodity and in monitoring its use by others. The persons utilizing the list were not permitted to utilize petitioner's name or organizational symbols in their mailings. Thus, the renters of the list were not making use for a fee of the intangible goodwill of DAV, its name, its recognized logo, or symbols. Providing the list was a business service for a fee, maintained by the organization for the express purpose of raising income. The names on the list had no specific relationship to the DAV other than as donors to the organization, or as potential donors, when used for DAV's own direct fund-raising purposes.

In determining whether activities generate royalty income, there is a valid distinction between active or passive activities. Under these circumstances, the use of an exempt organization's mailing list, unlike a payment to use a logo, does not associate the goodwill and good name of the exempt organization with the user. Indeed, here the petitioner, an IRC 501(c)(4) organization, required that there not be any reference to its identity in the mailings by others utilizing its list. Further, the petitioner maintained this service with active and continued effort to update the list, increase its size, and ensure its proper use by others. Activities involving the providing of services for profit are different from activities involving a royalty, which is the mere providing of a license to use an intangible asset. The providing of a mailing list in this case must be viewed as fundamentally different from the providing of a license to use a logo, trademark, or the like.