Rev. Rul. 60-86, 1960-1 C.B. 198

The operation of extensive club facilities, consisting of a restaurant, a bar and a cocktail lounge for members and guests, by an agricultural organization, exempt from Federal income tax under section 501(a) of the Internal Revenue Code of 1954 as an organization described in section 501(c)(5) of the Code, constitutes the carrying on of an unrelated trade or business within the meaning of section 513 of the Code. The organization is subject to the tax on the unrelated business income resulting from the operation of such facilities.

Advice has been requested whether income derived by an exempt agricultural organization from the operation of club facilities constitutes unrelated business income for purposes of the tax imposed by section 511(a) of the Internal Revenue Code of 1954.

The instant organization was formed as a nonprofit corporation to foster, aid and encourage the breeding, proper development, and care of the better types of breeds of horses. It was granted exemption from income tax under section 501(a) of the Code as an agricultural organization described in section 501(c)(5) thereof. It owns and operates a club house which serves as headquarters for its various activities.

In addition to its educational, instructive and other activities in the furtherance of agriculture, the organization is also engaged in the operation of a restaurant, a bar, and a cocktail lounge for its members and their guests. These latter activities are located in the club house and have been conducted on a year round-basis for a number of years. They provide over 50 percent of the organization's annual income. Less than 25 percent of its membership own horses or have any connection with their breeding or development.

Section 501(a) of the Code provides an exemption from Federal income tax for labor, agricultural and horticultural organizations as described in section 501(c)(5) of the Code. Such organizations contemplated by law as exempt are those which (1) have no net income inuring to the benefit of any member and (2) have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of certain organizations, including agricultural organizations, which are otherwise exempt from tax under section 501(a) of the Code, which is derived from any unrelated trade or business regularly carried on by such organizations.

Section 1.513-1 of the Income Tax Regulations states, in

part, that the income of an exempt organization is subject to taxation on unrelated business income if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the 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 which constitutes the basis for its exemption from tax.

Since the various club facilities involved are in the nature of a commercial enterprise and are regularly carried on, it is obvious that the first of the two conditions specified in the regulations for taxation of its business income is present in the instant case. Whether the other condition exists depends upon whether or not such business activities are substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its purpose or function constituting the basis for its exemption under section 501 of the Code. Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In some cases a business may be substantially related because it is incidental to or a necessary part of the exempt activity.

Although the operation of club facilities would be a necessary ingredient in carrying out the objectives of a social club as described in section 501(c)(7) of the Code, such facilities are not of primary concern to the furtherance of the purposes of an exempt agricultural organization. Certainly, such facilities, operated on the scale here involved, would not be either incidental to or required by such an organization in carrying out its educational or instructive purposes with respect to the development, care and breeding of the better types of breeds of horses. It also can be states in this connection that in determining whether particular activities are related to the exempt purposes of an organization such as the instant one, the important factor is the character of the activities rather than the source of their patronage.

In view of all the evidence presented, it is the position of the Internal Revenue Service that the activities in question are not operated primarily as a part of the organization's agricultural programs but for the convenience and enjoyment of its members and to provide a source of income in carrying out its functions in the furtherance of the purposes for which it was formed. It is concluded, therefore, that the operation of the club facilities, consisting of a restaurant, a bar and a cocktail lounge, constitute the carrying on of an unrelated trade or business within the meaning of section 513 of the Code.

Accordingly, it is held that the organization is subject to the tax under section 511 of the Code on the unrelated business income resulting from the operation of its club facilities.