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PROPOSED RULE MAKING

deductible in computing unrelated business taxable income. Since such items are incident to a function of the type which it is the chief purpose of the organization to conduct, they do not possess proximate and primary relationship to the unrelated trade or business. Therefore, they do not qualify as directly connected with that business.

(2) *Allowable deductions.* Where unrelated trade or business is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of such business, the expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the related activities; and

(ii) The allocation of such excess to the unrelated activities does not result in a loss from such unrelated trade or business.

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt function must be allocated first to the exempt function to the extent of the income derived from or attributable to the performance of that function. Furthermore, such items are in no event allocable to the unrelated business activities to the extent that their deduction would result in a loss carryover or carryback with respect to the particular conduct of trade or business involved. Similarly, they may not be taken into account in computing unrelated business taxable income attributable to the conduct of unrelated trade or business not exploiting the same exempt activities.

(3) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other commercial advertising materials to its members, charging the agency an agreed amount per enclosure. The production of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used full-time in the unrelated business and an allocable portion of the salaries of personnel used both to carry on exempt functions and to conduct the unrelated business. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business—W's membership—but are incurred primarily in connection with W's fundamental status and functioning as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business, and do not qualify as directly connected with it.

Example (2). Z, an exempt business league, publishes a monthly journal which it sells by subscription to members and others. The articles and other editorial content of the journal contribute importantly to the accomplishment of Z's exempt purposes. Therefore, the subscription income does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z derives income from the sale of advertising space to commercial advertisers. Since the provision of commercial advertising space does not contribute importantly to the accomplishment of Z's exempt purposes, Z's income from advertising constitutes gross income from unrelated trade or business. In computing Z's unrelated business taxable income, allowable deductions would (subject to the rules provided in section 162 and other relevant sections of the Internal Revenue Code) include the specific costs of the advertising activity, such as advertising copy and mechanical costs, advertising sales commissions and similar expenses. Also allowable would be items of deduction (such as general overhead expenses and depreciation) allocable to the advertising activity in accordance with the rule of paragraph (e) of this section. In addition, since expenses, depreciation, and similar items related to the production and distribution of the editorial content of the journal are costs generally incurred by taxable organizations publishing journals with advertising, such items will be treated as directly connected with the conduct of the unrelated trade or business. Thus, subject to the limitations of subdivisions (i) and (ii) of subparagraph (2) of this paragraph, they would be allowable as deductions in computing Z's unrelated business taxable income to the extent provided in section 162, section 167, and other relevant sections of the Internal Revenue Code.

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