

## **I. IRC 513 - DEVELOPMENTS IN ADVERTISING INCOME**

### **1. Introduction**

The purpose of this topic is to discuss advertising income, the computation of tax on such income, and the recent Court of Appeals decision in The American College of Physicians v. U.S., 54 AFTR 2d 84-5941 (C.A. Fed.) (1984), which holds that advertising in an exempt organization's journal was substantially related to its exempt purpose or function.

By raising the possibility that at least some kinds of advertising produce related income, this decision represents a significant new area of inquiry with respect to advertising income. Until this decision, the Service felt confident that virtually all true advertising was unrelated and consequently most of the Service's time and attention in the area of advertising income was devoted to issues involving merely the computation of tax and the allocation or allowability of various deductions.

#### **A. Code Provisions**

IRC 511(a)(1) imposes a tax on the unrelated business taxable income of organizations described in IRC 401, 501(c) and on certain State colleges and universities. IRC 512(a)(1) defines "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business (as defined in IRC 513) regularly carried on by it, less deductions and modifications. IRC 513(a) 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 its exempt purpose or function.

As part of the Tax Reform Act of 1969, subsection (c) was added to IRC 513 to cover advertising and other activities. IRC 513(c) provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of

such trade or business shall be excluded from such classification merely because it does not result in profit.

## B. Regulations

Reg. 1.512(a)-1(f) states that under IRC 513 and Reg. 1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business activity involving the exploitation of an exempt activity, namely, the circulation and readership content of the periodical. Reg. 1.512(a)-1(f)(4) through (6) provides rules for determining the amount of unrelated business taxable income attributable to the sale of advertising in exempt organizations periodicals. The issue of allocation of costs to exempt organizations periodicals was discussed in the 1982 Continuing Professional Education text.

Reg. 1.513-1(d)(1) provides that gross income derives from "unrelated trade or business", within the meaning of IRC 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 that 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.

Reg. 1.513-1(d)(2) states 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 IRC 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 an 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.

Reg. 1.513-1(d)(4)(iv) provides that in certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income they produce is gross income from the conduct of unrelated trade or business. This regulation contains two relevant examples that illustrate the Service position that publication of advertising in an exempt organization's journal does not contribute importantly to the accomplishment of the organization's exempt purpose. The following is the text of the two examples:

Example (6). Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z also derives income from the regular sale of space and services for general consumer advertising, including advertising of such products as soft drinks, automobiles, articles of apparel, and home appliances. Neither the publication of such advertisements nor the performance of services for such commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted. Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in performance of exempt functions, such income is gross income from unrelated trade or business.

Example (7). The facts are as described in the preceding example, except that the advertising in Z's journal promotes only products which are within the general area of professional interest of its members. Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates. Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and in its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business.

The regulations also contain the following example which describes a situation where advertising income does not constitute unrelated business taxable income:

Example (5). Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by means of student instruction of other students in the editorial and advertising activities and student participation in those activities.

### C. Handbook Provisions

Chapter 37(30) of IRM 7751, Exempt Organizations Handbook, discusses computation and allocation questions. The text of the relevant Handbook provisions is reprinted here.

**(37)30 (3-15-82) 7751**  
**Sale of Advertising In Exempt**  
**Organization Periodicals**

**(37)31 (3-15-82) 7751**  
**Advertising Unrelated Business**  
**Taxable Income**

(1) The sale of advertising in a periodical of an exempt organization that contains editorial material related to the accomplishment of its exempt purpose is exploitation of an exempt function of the kind discussed in text (37)24:(3) above. Regs. 1.512(a)-1(f) provide rules for determining the amount of unrelated business taxable income attributable to the sale of such advertising.

(2) For the purpose of arriving at the amount of unrelated business taxable income attributable to the sale of advertising it is necessary to determine the gross advertising income, direct advertising costs, circulation income and readership costs. If membership fees are to be allocated to the periodical it may also be necessary to determine the total periodical costs. These terms are defined in text (37)32.

(3) If the direct advertising costs exceed the gross advertising income, the excess is allowable as a deduction in determining the unrelated business taxable income from any other unrelated trade or business activity carried on by the organization. Regs. 1.512(a)-1(f)(2).

(4) If, however, the gross advertising income of the periodical exceeds the direct advertising costs, items of deduction attributable to the production and distribution of the readership content of the periodical (its exempt function) may be deducted from the "excess advertising income" in computing unrelated business taxable income, to the extent such deductions exceed "circulation income" (income from the exempt function) but may not result in a loss from the advertising activity. Such deductions may be taken into account in computing the unrelated business taxable income from this activity only. Regs. 1.512(a)-1(d).

(5) Thus, if the circulation income of the periodical equals or exceeds the readership costs of such periodical, the unrelated business taxable income attributable to the periodical is the excess of the gross advertising income of the periodical over direct advertising costs; but if the readership costs of an exempt organization periodical exceed the circulation income of the periodical, the unrelated business taxable income is the excess, if any, of the total income attributable to the periodical over the total periodical costs. This results in advertising income of an exempt organization periodical being taxed only if the periodical produces an overall profit for the year.

**(37)32 (3-15-82) 7751**  
**Income and Deductions**  
**Attributable to Exempt**  
**Organization Periodicals**

(1) Gross advertising income is defined in Regs. 1.512(a)-1(f)(3) as all amounts derived from the unrelated advertising activities of the exempt organization.

(2) Circulation income is defined as the income attributable to the production, distribution or circulation of a periodical (other than the gross advertising income) including all amounts realized from or attributable to the sale or distribution of the readership content of the periodical. This includes amounts realized from charges made for reprinting or republishing articles and special items in the periodical and amounts realized from the sale of back issues. Regs 1.512(a)-1(f)(3).

(3) Total periodical costs (the total deductions attributable to the periodical) are equal to the sum of the direct advertising costs of the periodical and the readership costs of the periodical.

(4) Direct advertising costs include all expenses, depreciation, and similar items of deduction which are directly connected with the sale, publication and distribution of advertising. Regs. 1.512(a)-1(f)(6)(ii)(a).

(5) Readership costs are expenses, depreciation, or similar items which are directly connected with the production and distribution of the readership content of the periodical. Thus, all the deductions that are attributable to an exempt organization periodical that are not allocated to direct advertising costs are included under readership costs. Regs. 1.512(a)-1(f)(6)(iii).

(6) The mechanical and distribution costs must be allocated between the direct advertising costs and the readership costs. Unless a more accurate method is available, these costs should be allocated on

the basis of lineage. Thus, mechanical and distribution costs are allocated to advertising costs on the basis that the ratio of advertising lineage bears to total lineage. Regs. 1.512(a)-1(f)(6)(ii)(e).

**(37)33 (3-15-82) 7751**  
**Allocation of Membership Fees to Exempt Organization Periodicals**

(1) Where the right to receive an exempt organization periodical is associated with membership for which fees are received, subscription income includes the portion of membership fees allocable to the periodical. Regs. 1.512(a)-1(f)(4) sets out three methods for allocating membership receipts to a periodical:

(a) If 20 percent or more of the total circulation of a periodical consists of sales to nonmembers, the price of the periodical for purposes of allocating membership receipts is the subscription price charged to nonmembers.

(b) If paragraph (a) does not apply and 20 percent or more of the organization's members pay lower dues than other members because the former do not receive the periodical, allocation is based on the difference in membership fees paid. The price of the periodical is the amount of the reduction in membership dues for a member not receiving the periodical.

(c) Where neither paragraph (a) nor (b) applies, Regs. 1.512(a)-1(f)(4)(iii) provides a formula for the pro rata allocation of membership receipts based on the assumption that membership receipts and gross advertising income are equally available for all an organization's exempt activities including the periodical.

(d) The share of membership receipts allocated to the periodical under this method is 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.

(2) A detailed example of the allocation of membership receipts to advertising income under the formula given in Regs. 1.512(a)-1(f)(4)(iii) is contained in Rev. Rul. 81-101, 1981-1 C.B. 352. This ruling illustrates that in applying such formula the phrase "cost of other activities" means the total costs or expenses incurred by an organization in connection with its other exempt activities and such costs are not offset by any income earned by the organization from such activities.

(3) Several other examples of the application of the allocation rules are contained in Regs. 1.512(a)-1(f)(5).

**(37)34 (3-15-82) 7751**  
**Examples**

(1) The following examples are contained in Regs. 1.512(a)-1(f)(2)(iii).

(a) Example (1). X, an exempt trade association, publishes a single periodical which carries advertising. During 1971, X realizes a total of \$40,000 from the sale of advertising in the periodical (gross advertising income) and \$60,000 from sales of the periodical to members and nonmembers (circulation income). The total periodical costs are \$90,000 of which \$50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and \$40,000 is attributable to the production and distribution of the readership content (readership costs). Since the direct advertising costs of the periodical (\$50,000) exceed gross advertising income (40,000), the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

Gross advertising revenue	\$ 40,000
Direct advertising costs	(50,000)
Loss attributable to advertising	(10,000)

X has realized a loss of \$10,000 from its advertising activity. This loss is an allowable deduction in computing X's unrelated business taxable income derived from any other unrelated trade or business activity.

(b) Example (2). Assume the facts as stated in example (1), except that the circulation income of X periodical is \$100,000 instead of \$60,000, and that of the total periodical costs, \$25,000 are direct advertising costs, and \$65,000 are readership costs. Since the circulation income (\$100,000) exceeds the total readership costs (\$65,000) the unrelated business taxable income attributable to the advertising activity is \$15,000, the excess of gross advertising income (\$40,000) over direct advertising costs (\$25,000).

(c) Example (3). Assume the facts as stated in example (1), except that of the total periodical costs, \$20,000 are direct advertising costs and \$70,000 are readership costs. Since the readership costs of the periodical (\$70,000), exceed the circulation income (\$60,000), the unrelated business taxable income attributable to advertising is the excess of the total income attributable to the periodical over the total periodical costs. Thus, X has unrelated business taxable income attributable to the advertising activity of \$10,000 (\$100,000 total income attributable to the periodical less \$90,000 total periodical costs).

(d) Example (4). Assume the facts as stated in example (1), except that the total periodical costs are \$120,000 of which \$30,000 are direct advertising costs and \$90,000 are readership costs. Since the readership costs of the periodical (\$90,000), exceed the circulation income (\$60,000), the unrelated business taxable income attributable to advertising is the excess, if any, of the total income attributable to the periodical over the total periodical costs. Since the total income of the periodical (\$100,000) does not exceed the total periodical costs (\$120,000), X has not derived any unrelated business taxable income from the advertising activity. Further, only \$70,000 of the \$90,000 of readership costs may be deducted in computing unrelated business taxable income since such costs may be deducted, to the extent they exceed circulation income, only to the extent they do not result in a loss from the advertising activity. Thus, there is no loss from such activity, and no amount may be deducted on this account in computing X's

unrelated trade or business income derived from any other unrelated trade or business activity.

Chapter (37)33:(2) of IRM 7751 refers to Rev. Rul. 81-101, 1981-1 C.B. 352, which holds that in applying the allocation formula of Reg. 1.512(a)-1(f)(4)(iii), 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. This clarifies the position set forth in the 1979 Continuing Professional Education Text (Exempt Organizations Annual Technical Review Institute), which stated that exempt activity costs must be reduced by related items of income.

The Service is currently considering two questions concerning the allocation formula. Our current thinking is that when members pay dues on a sliding scale, all membership dues are used in the formula even though some members pay more than others. Another question being considered concerns an organization that publishes a periodical with advertising which members receive, but which is also distributed to nonmembers without charge or at a nominal charge. Under these circumstances, our current thinking is that allocable membership receipts must be determined in accordance with Reg. 1.512(a)-1(f)(4)(iii) (assuming that Reg. 1.512(a)-1(f)(4)(ii) does not apply) when over 20% of all distributions of the periodical are made to nonmembers without charge or at a nominal charge. This position would not allow organizations to reduce their circulation income through free distribution of their periodicals.

## 2. Background - Revenue Rulings

The issue of whether income derived from the sale of space in a journal is unrelated business taxable income has been the subject of a number of revenue rulings. Rev. Rul. 74-38, 1974-1 C.B. 144, describes an organization exempt under IRC 501(c)(6), which publishes a monthly journal containing articles and other editorial material of professional interest to its members. The organization derives income from the sale of space in its journal for conventional advertising or other messages as the purchasers direct. Most of the space sold for such purposes is devoted to ordinary advertising which features the products or services of a commercial enterprise. However, some of the space merely identifies the purchaser without any further advertising message. After citing IRC 513(c) and Reg. 1.513-1(d)(4)(iv), the revenue ruling notes that publication and distribution of advertising and other messages in periodicals is a recognized form of commercial service; the regular sale of space for such purposes is carried on for the production of income



and constitutes the conduct of trade or business, and the fact that the message published may not be of a commercial nature is not determinative. The revenue ruling states that the controlling factor is that activities giving rise to the income in question constitute the sale and performance of a valuable service on the part of the publisher, and the purchase of that service on the part of the other party to the transaction. Since the publication of the advertising and other messages is regularly carried on and is not substantially related to the exercise or performance of the exempt organization's exempt function, amounts derived therefrom constitute gross income from unrelated trade or business.

Rev. Rul. 74-38 was clarified by Rev. Rul. 76-93, 1976-1 C.B. 170, which describes an organization exempt under IRC 501(c)(3) that publishes a journal and derives income from the sale of space for conventional advertising or other messages. Some of the space sold is devoted to ordinary advertising; however, most of the space is merely used to identify the purchaser and contains no advertising message. The journal is described as consisting of 95 pages of which 60 are devoted to identifying various national and local business firms in separate "blocked-in" spaces (full page, 1/2, 1/3, 1/4, 1/5, 1/8, 1/10, and 1/16 page) or part of a "listing" (a listing of 60 or more firms per page). After setting forth a number of factors to be considered in such cases, the revenue ruling concludes that income from the advertising constitutes unrelated business taxable income, except that which was derived from the 60-to-a-page listing. Any commercial benefit derived from 60-to-a-page listing was thought to be negligible and inconsequential.

Rev. Rul. 82-139, 1982-2 C.B. 108, provides that the income from the advertising of products and services used by the legal profession, in a bar association journal, was income from unrelated trade or business. Even though the advertising was directed specifically to members of the legal profession, it was still commercial in nature and represented an effort on the part of advertisers to maximize sales to a particular segment of the public. Therefore, the publication of these advertisements did not further the purposes of the bar association. A distinction was made in this ruling for statutory legal notices, which were related, since the purpose of such notices was to inform the public of significant legal events rather than to stimulate demand for the products or services of the advertiser.

### 3. Legislative History

The legislative history of IRC 513 supports the taxation of advertising income. House Report 91-413 (Part I) 1st Session, on the Tax Reform Act of 1969,

1969-3 C.B. 200, 232, 6. Income from advertising, etc. states, in part, addressing the advertising issue:

Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes that this income should be taxed. (Emphasis supplied).

Later in describing then to be enacted IRC 513(c):

... (I)t is anticipated that advertising income from publications (whether or not the publications are related to the exempt purpose of the organization) will constitute unrelated business income.

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Where an unrelated business activity, such as the sale of advertising in a publication of a tax-exempt organization, or other commercial exploitation of the exempt function of a tax-exempt organization, is carried on in conjunction with such exempt function, the Secretary or his delegate is to prescribe regulations respecting the allocation of income and expenses and other deductions which are attributable to the unrelated activity so as to clearly reflect unrelated business taxable income from such activity and to prevent avoidance of unrelated business income tax liability.

Senate Report 91-552, 1st Session, Tax Reform Act of 1969, 1969-3 C.B. 423, 475, 6. Income from Advertising etc. elaborates on the House Report:

Present Law. -- In December 1967, the Treasury Department promulgated regulations under which the income from advertising and similar activities is treated as "unrelated business income" even though such advertising for example may appear in a periodical related to the educational or other exempt purpose of the organization.

The committee agrees with the House that the regulations reached an appropriate result in specifying that when an exempt

organization carries on an advertising business in competition with other taxpaying advertising businesses, it should pay a tax on the advertising income.

... the committee agrees with the House that the regulations, insofar as they apply to advertising and related activities should be placed in the tax laws.

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The Senate Report makes clear that when IRC 513(c) speaks of a trade or business, including any activity "carried on for the production of income", it is not intended to refer to the publishing of a magazine with little or no advertising and which is distributed free or at a nominal charge not intended to cover costs. This type of magazine would appear to be published basically as a source of public information and not for the production of income. If such a magazine generated little or no advertising income, losses therefrom could not be used to offset gains from other activities. For a publication to be considered an activity carried on for the production of income, it must be contemplated that the revenue from advertising in the publication or the revenues from sales of the publication, or both, will result in the net income (although not necessarily in a particular year).

#### 4. American College of Physicians

##### A. The Organization

The American College of Physicians is an organization recognized as exempt under IRC 501(c)(3). Its purposes include upholding and maintaining high standards in medical education, medical practice, and medical research; encouraging research, especially in clinical medicine; and fostering measures for the preventing of disease and for the improvement of public health.

Membership in the organization is limited to members of the medical profession engaged in practice, teaching, research, or other pursuits in the field of internal medicine or in allied or related specialties.

In furtherance of these purposes, the organization publishes a journal called Annals of Internal Medicine. The journal contains scholarly articles relevant to the practice of internal medicine, advertisements of medical products, supplies and equipment useful in the practice of internal medicine, and notices of positions

desired or available in connection with the practice of internal medicine. The organization's members receive the journal as a benefit of membership while nonmembers may acquire the journal by subscription or per issue. Advertisements in the journal are "stacked" in two sections - at the front of, and behind, the editorial content of each issue. Advertisements in medical journals published by commercial organizations are generally also grouped in stacks rather than dispersed throughout an issue. Advertisements were prepared by the advertisers and not by the organization. Advertising space was made available in the journal at rates competitive with those charged by commercial organizations for advertising space in their medical journals. The organization's policy is to accept only those advertisements relating to medical products (primarily drugs), supplies, and equipment useful in the practice of internal medicine. Preferred advertisements are screened for accuracy and relevance to internal medicine.

In the 1975 tax year, gross advertising income attributable to the journal was \$1,376,322. Direct advertising costs were \$833,050. Circulation income and readership costs attributable to the journal were \$1,057,754 and \$1,351,167 respectively. Another of the organization's publications produced a loss of \$96,471. The organization reported taxable income of \$153,388 and paid federal income taxes of \$55,965 for the 1975 tax year. The organization timely filed a claim for a refund of those taxes and subsequently filed a suit for a refund of the taxes in the United States Claims Court.

#### B. The Lower Court Decision

In American College of Physicians v. United States, 3 Cl. Ct. 531, 52 AFTR 2d 83-6176 (1983), the Claims Court held that the organization was not entitled to a refund on taxes paid in connection with its advertising income. The Claims Court found the advertisements to be unrelated to the organization's exempt purpose or function. The trial judge found that many of the ads appearing in the journal were identical to those appearing in medical journals published by non-exempt organizations. He also found that the journal's advertising business was operated in material respects like the advertising business of any other publication. The Court noted that the manner in which the advertising activity was conducted did not support the organization's assertion that the advertising contributed importantly to the education of its members because the ads did not attempt to present a comprehensive survey of the products and were repeated month after month; and some ads bore no conceivable relationship to the organization's exempt purposes. The Court concluded:

To avoid the [unrelated business income tax] an exempt organization would have to run its advertising business much differently than did plaintiff. For example, it might make a concerted effort to provide advertising that comprehensively surveys a particular field, includes all recent developments in that field, or otherwise makes a systematic presentation on some subject relevant to the organization's exempt purpose.

[t]o qualify for exemption, the advertising package as a whole must serve an identifiable educational objective that goes substantially beyond the informational content of the individual advertisements. This standard is not met where, as here, the comprehensiveness and content of the advertising package is entirely dependent on each manufacturer's willingness to pay for space and the imagination of its advertising agency.

The court also found the advertising did not escape tax under the exception provided by IRC 513(a)(2) because the advertising was not an activity carried on primarily for the convenience of the members.

### C. The Court of Appeals Decision

The organization appealed the Claims Court decision to the Court of Appeals for the Federal Circuit. The Appeals Court reversed the Claims Court holding that the trial court's finding as to relatedness was clearly erroneous.

In arriving at its decision, the Appeals Court construed the legislative history of IRC 513(c) to the effect that, in its view, Congress amended the statute only to provide that advertising activity shall be treated as a separate trade or business for purposes of analysis. The Court's statutory construction rests on the belief that Congress made no change in the "substantially related" and "convenience" tests of IRC 513(a), and that Congress did not intend to tax all advertising revenue of all journals of exempt organizations; even if it did so intend, the statute does not contain appropriate language in furtherance of such intent.

The argument was made by the government that IRC 513(c), as a specific statutory provision, was controlling over the more general provision, IRC 513(a), in much the same way that IRC 501(e) is the specific exclusive statutory provision with respect to cooperative hospital service organizations. The Court rejected the argument and distinguished HCSC-Laundry v. United States, 450 U.S. 1 (1981),

which held that a cooperative hospital service organization cannot qualify for exemption under IRC 501(c)(3), but instead may qualify only under IRC 501(e).

The Appeals Court was critical of the trial court's imposition of a more strict standard than that required by the statute. As noted previously, the Claims Court alluded to the possibility of the relatedness test being met where an organization's advertising consisted of a comprehensive survey in furtherance of an identifiable educational objective above and beyond mere informational content. Example 7 of Reg. 1.513-1(d)(4)(iv) also distinguishes between the informational content of advertising and the educational activity of an exempt organization. Although acknowledging that comprehensive and systematic presentations would enhance the relationship between the advertisements and the organization's exempt purpose or function, the Appeals Court felt that the absence of such a comprehensive presentation was not fatal with respect to meeting the relatedness test. In the view of the Appeals Court, the trial court had placed unwarranted emphasis on the similarity of the organization's activity to commercial advertising, while failing to analyze adequately the relationship between the activity and the organization's exempt purpose or function. The Appeals Court believes that the trial court was "... apparently distracted by the commercial character of the advertisements and failed to focus properly on the substantiality of the relation of the information content of the advertisements to the [organization's] educational function."

A fair reading of the Appeals Court decision reveals that a certain amount of emphasis was placed on the following evidence:

1. The organization's exempt purpose or function was the medical education of internists including, but not limited to, dissemination of medical and pharmaceutical information.
2. Testimony of the organization's expert witnesses regarding the need for continuing pharmacologic information, particularly in view of the rapid pace of developments in internal medicine.
3. Testimony regarding the essential function performed by drug advertising to disseminate information on recent developments with respect to new drugs, changes in dosage forms and strengths of existing drugs, and additional indications and contraindications discovered based on use.

4. Testimony by the organization's expert witnesses that the advertising performed an essential alerting function to inform the physician of recent developments by disseminating information concerning those developments.
5. Evidence that the advertising carried in the journal is screened with respect to subject matter and its content controlled.
6. Advertising is accepted only of products and services related to the practice of internal medicine.
7. The accuracy of information in the advertisements appearing in the journal is regulated, in part, by information mandated by the Food and Drug Administration.
8. The organization screens new advertisements for relevance to the practice of internal medicine.
9. Classified advertisements in the journal are limited to advertisements directly relevant to the practice of internal medicine.
10. Advertisements are indexed by advertiser.

Based on all the evidence presented by the organization, and in view of the previously discussed statutory construction of IRC 513(c), the Appeals Court concluded that the advertisements contribute importantly to the organization's exempt purpose, and that the sales of advertising in the journal are substantially related to the organization's exempt purpose to educate internists, and therefore are not taxable under IRC 511. The opinion ends with the observation that not all the advertisements published in a journal necessarily meet the "substantially related" test; a footnote refers to an advertisement for a magazine offering financial and business advice for practicing physicians. The Court declined to resolve the issue of whether some portion of the advertising in the journal was in excess of what would be reasonably necessary for performance of its exempt function because the government did not make such argument.

## 5. Conclusion

At this time the possible consequences and implications of the decision in American College of Physicians v. U.S. are receiving extensive consideration. From a technical perspective, the decision appears to render meaningless any real distinction between nonexempt informational purposes and exempt educational purposes. The continuing validity of the previously mentioned regulations on advertising income and the examples contained therein, together with the cited revenue rulings, is uncertain. Although the court opinion mentioned neither the regulations example nor the revenue rulings, their holdings are obviously inconsistent with the court decision. From a practical perspective, many similarly situated exempt organizations that publish journals will undoubtedly cite American College of Physicians v. U.S. and assert that their advertisements are also substantially related to their exempt purpose or function. Educational organizations, business leagues and trade associations in particular can all be expected to argue that income derived from the sale of space in their journals is not unrelated business taxable income because the "relatedness" test is met. If such a position is deemed to have widespread application, complaints of unfair competition will be heard from commercial organizations that publish journals. The potential impact of this decision should not be minimized since it could ultimately affect tens of millions of pounds of advertising delivered by the Postal Service (according to Postal Service statistics), and result in a loss of millions of dollars of tax revenue.

On October 31, 1984, the Justice Department filed a petition for rehearing with a suggestion for rehearing en banc in this case. As of the date this topic was being prepared, no decision had been made concerning a rehearing.