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REPORT
No. 1118

SECTION 512(b) OF INTERNAL REVENUE CODE

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Mr. SMATHERS, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 6455]

The Committee on Finance, to whom was referred the bill (H.R. 6455) to amend subsection (b) of section 512 of the Internal Revenue Code of 1954 (dealing with unrelated business taxable income), having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

I. SUMMARY

This bill provides an exemption from the tax on unrelated business taxable income in the case of labor unions and agricultural or horticultural organizations where three conditions are met. First, the income must be used to establish, maintain, or operate a retirement home, hospital, or similar facility for the exclusive use of aged and infirm members of the labor union or agricultural or horticultural organization. Second, the income must be derived from agricultural pursuits conducted on ground contiguous to the home, hospital, etc. Third, this income may not represent more than 75 percent of the cost of maintaining and operating the home, etc.

This provision, as amended by the committee, is to apply with respect to taxable years beginning after December 31, 1963.

II. GENERAL STATEMENT

Present law.—Present law provides that certain otherwise tax-exempt organizations are to be subject to tax on any "unrelated business taxable income." "Unrelated business taxable income" for this purpose is defined as excluding the various forms of passive income such as dividends, interest, etc. It includes income from the active conduct of a trade or business which is not substantially related

(apart from the organization's need for profits) to the exempt purpose of the organization in question.

This tax on unrelated business income under present law applies to labor, agricultural, horticultural organizations (described in sec. 501 (c)(5)); business leagues, chambers of commerce, real estate boards, etc. (sec. 501 (c)(6)); educational, charitable, religious (except churches or conventions or associations of churches), and similar organizations (sec. 501(c)(3)); corporations organized to hold title to property and turn over the proceeds, less expenses, to an exempt organization (sec. 501(c)(2)); trusts forming a part of a plan providing for the payment of supplemental unemployment compensation benefits (sec 501 (c)(17)); and qualified pension, profit sharing, and stock bonus plans (sec. 401(a)). The tax on unrelated business income does not presently apply in the case of fraternal beneficiary societies, orders, or associations, civic leagues and similar organizations, local life insurance associations, as well as several other categories of exempt organizations.

Reasons for the bill.—A situation has been brought to attention where a labor union maintains a retirement home, hospital, and similar facilities for the benefit of the aged or infirm members of the union. A significant portion of the income used to maintain this home is derived from agricultural pursuits on ground immediately adjacent to the union's home for its aged.

Under present law, the income derived from such agricultural pursuits has been held to be unrelated business taxable income and, therefore, subject to tax. Your committee, like the Ways and Means Committee of the House, believes that this is an undesirable result in cases of this type where the combination of a number of factors indicate that relief from this tax is appropriate.

If the income were derived by a fraternal order from the same source and used for a retirement home for its members, under present law, the income would not be taxed. Your committee believes that in situations of this type, where the income is derived from property adjacent to the retirement home, and represents income from an agricultural pursuit but at the same time does not account for all of the expenses of maintaining the retirement home—coupled, with the similarity of the types of organizations covered to those of fraternal orders—exemption of the income from tax is justified. In addition, there is also the fact that if the union were to enter into a rental arrangement whereby someone else takes the profit risk, the rental income it would derive would be exempt from tax. Exemption in this case, therefore, is denied only because the profit element is retained by the labor union rather than going to a taxable organization.

Explanation of the bill.—The bill provides an exemption (sec. 512(b)(14)) from the tax on unrelated business taxable income for the type of case described above. The exemption applies only in the case of a labor union or agricultural or horticultural organization (described in sec. 501(c)(5)), and for the exemption to be available several requirements must be met.

First, all of the income must be used to establish, maintain, or operate a retirement home, hospital, or similar facility for the exclusive use and benefit of the aged and infirm members of the labor union or agricultural or horticultural organization. A member of the organization would be considered "aged" for this purpose if he has

attained the retirement age at which employees customarily retire in the company or industry in which he was last employed. A member would be considered as infirm if he is sufficiently feeble as not to be able to carry on his prior work even though he has not attained the customary retirement age.

Second, the income must be derived from agricultural pursuits conducted on ground contiguous to the retirement home, hospital, or similar facility.

Third, the gross income derived from the agricultural pursuits described above must not provide more than 75 percent of the cost of maintaining and operating the retirement home, hospital, or similar facility.

The bill also provides that items of expense, etc. (allowed by ch. 1 of the code) directly connected with the gross income excluded from tax by this provision are not to be allowed as deductions in measuring tax on any other income. This is in conformity with the treatment of deductions provided for other exclusions under present law in the case of the tax of unrelated business taxable income.

Effective date.—This provision, as approved by the committee, is to apply to taxable years beginning after December 31, 1963, rather than after 1962, as provided by the House bill.

Revenue effect.—It is believed that the revenue loss resulting from the enactment of this bill will be negligible.

CHANGES IN EXISTING LAW

In compliance with subsection 4 of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill are shown as follows (existing law proposed to be omitted is enclosed in black brackets; new matter is printed in italic; existing law in which no change is proposed is shown in roman):

SECTION 512(b) OF THE INTERNAL REVENUE CODE OF 1954

SEC. 512. UNRELATED BUSINESS TAXABLE INCOME

* * * * *

(b) EXCEPTIONS, ADDITIONS, AND LIMITATIONS. The exceptions, additions, and limitations applicable in determining unrelated business taxable income are the following:

(1) There shall be excluded all dividends, interests, and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a business lease (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

(6) The net operating loss deduction provided in section 172 shall be allowed, except that—

(A) the net operating loss for any taxable year, the amount of the net operating loss carryback or carryover to any taxable year, and the net operating loss deduction for any taxable year shall be determined under section 172 without taking into account any amount of income or deduction which is excluded under this part in computing the unrelated business taxable income; and

(B) the terms "preceding taxable year" and "preceding taxable years" as used in section 172 shall not include any taxable year for which the organization was not subject to the provisions of this part.

(7) There shall be excluded all income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof; and there shall be excluded all deductions directly connected with such income.

(8) In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(9) In the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, there shall be excluded all income derived from research performed for any person and all deductions directly connected with such income.

(10) In the case of any organization described in section 511(a), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 5 percent of the unrelated business taxable income computed without the benefit of this paragraph.

(11) In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1) (A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

(12) There shall be allowed a specific deduction of \$1,000.

(13) In the case of a trust—

(A) created by virtue of the provisions of the will of an individual who died after August 16, 1954, and before January 1, 1957.

(B) which, by virtue of the provisions of such will, is a limited partner in a partnership created under the laws of a State (i) providing for the creation of limited partnerships, and (ii) under which a limited partner has no right to take part in the control of the business without becoming liable as a general partner.

(C) which, at no time before or during a taxable year of the partnership ending within or with the taxable year of the trust, was (or was liable as) a general partner in such partnership, and

(D) which is required to distribute all of its income (within the meaning of section 643(b)) currently exclusively for religious, charitable, scientific, literary, or educational purposes, and which is required to distribute all of the corpus exclusively for such purposes.

there shall be excluded its share (determined under subsection (c) without regard to this paragraph and paragraph (11)) of gross income of the partnership as such limited partner and of the partnership deductions directly connected with such income, but, if such share of gross income exceeds such share of deductions, only to the extent that the partnership makes distributions during its taxable year which are attributable to such gross income. For purposes of the preceding sentence (i) any distribution made after the close of a partnership taxable year and on or before the 15th day of the fourth calendar month after the close of such taxable year shall be treated as made on the last day of such taxable year, and (ii) distributions shall be treated as attributable first to gross income other than gross income described in the preceding sentence, and shall be properly adjusted (under regulations prescribed by the Secretary or his delegate) to the extent necessary to reflect capital contributions to the partnership made by the trust, income of the partnership exempt from tax under this title, and other items.

(14) In the case of an organization which is described in section 501(c)(5), there shall be excluded all income used to establish, maintain, or operate a retirement home, hospital, or other similar facility for the exclusive use and benefit of the aged and infirm members of such an organization, which is derived from agricultural pursuits conducted on ground contiguous to the retirement home, hospital, or similar facility and further provided that such income does not provide more than 75 percent of the cost of maintaining and operating the retirement home, hospital, or similar facility; and there shall be excluded all deductions directly connected with such income.

