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The Tax-Exempt Business League and Its Functions

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THE TAX-EXEMPT BUSINESS LEAGUE AND ITS FUNCTIONS

"Business leagues, chambers of commerce, real-estate boards, [and] boards of trade" are presently exempted from federal income tax.[1] The common denominator of these organizations is the promotion of some sort of business interest on a nonprofit basis. A business league is defined in the Treasury Regulations as "an association of persons having some common business interest, the purpose of which is to promote such common business interest."[2] It is further distinguished from the other organizations exempted by Section 501(c)(6) of the Internal Revenue Code by the requirement that "its activities should be directed to the improvement of business conditions of one or more lines of business. . . ."[3] By contrast, a chamber of commerce promotes business prosperity in a particular locality,[4] a real-estate board serves an entire profession, and a board of trade advances business interests generally.[5]

Promotion of the common business interests of members has involved many different activities in all areas of commerce. Business leagues have been formed to advertise the agricultural product of a particular area on a cooperative basis,[6] to publish and distribute trade journals,[7] to conduct trade and industrial shows,[8] to educate consumers regarding the proper use of retail credit,[9] and to improve the public image of a product and its users.[10] These services are appropriate for a business league because they are not likely to be performed as a regular business for profit and could not be carried on as efficiently by an individual within the line of business. For this reason, business leagues are considered "an efficient means by which those engaged independently in a particular line of trade may redress wrongs and improve conditions through collective action."[11] Business leagues, then, have made a unique contribution to business and industry.

Business-league activities have been described as semi-civic and are considered to be in the interests of the general welfare[12] because they promote a line of business generally rather than the private interests of individual competitors. Whether such activities should be the proper subject of tax exemption, however, is beyond the scope of this comment, which, instead, will

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1 Int. Rev. Code of 1954, § 501(c)(6).

2 Treas. Reg. § 1.501(c)(6)-1 (1958).

3 Ibid.

4 Retailers Credit Ass'n v. Commissioner, 90 F.2d 47, 51 (9th Cir. 1937).

5 Ibid.

6 Washington State Apples, Inc. v. Commissioner, 46 B.T.A. 64 (1942), acq., 1942-1 Cum. Bull. 17.

7 National Leather & Shoe Finders Ass'n v. Commissioner, 9 T.C. 121 (1947), acq., 1947-2 Cum. Bull. 3.

8 American Woodworking Mach. & Equip. Show, Inc. v. United States, 249 F. Supp. 392 (M.D.N.C. 1966).

9 Retail Credit Ass'n v. United States, 30 F. Supp. 855 (D. Minn. 1938).

10 Texas Mobile Homes Ass'n v. Commissioner, 324 F.2d 691 (5th Cir. 1963).

11 Davies, Trust Laws and Unfair Competition 705 (1915).

12 Webster, Federal Tax Aspects of Association Activities vii (1959).

be confined to an analysis of section 501(c)(6) and the applicable regulation. The intent is to show how the statute has been interpreted and applied in matters involving the organizations which have sought exemption as business leagues.

I. Requirements for the Exemption

Congress has said very little about business leagues in the statute establishing the exemption. Section 501(c)(6), however, stipulates as conditions for exemption that a business league may neither be organized for profit, nor use any of its net earnings for the benefit of any private shareholder or individual. The administrative details were left for the Internal Revenue Service to formulate. The IRS responded with a detailed and lengthy regulation which, in addition to defining a business league, established conditions for the granting of the exemption.[13]

The Tax Court has clarified this regulation by enumerating five specific requirements for a group seeking the exemption:

> (1) It must be "an association of persons having a common business interest"; (2) its purpose must be to promote that common business interest; (3) "its activities should be directed to the improvement of business conditions of one or more lines of business"; (4) it should not be engaged in a regular business of a kind ordinarily carried on for profit; and (5) its activities should not be confined to "the performance of particular services for individual members."[14]

An organization must comply with all of these requirements to receive the exemption.

The definition of a business league as established by the regulation has not been a major source of litigation under section 501(c)(6). A good-faith attempt to promote almost any *business* interest common to the members is sufficient to meet the initial basic requirements. If, however, membership is available to individuals without regard to their business interests or activities, the requirement of a common business interest has not been met.[15]

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[13] Treas. Reg. § 1.501(c)(6)-1 (1958) states in part:

> A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax.

[14] Associated Indus. v. Commissioner, 7 T.C. 1449, 1465-66 (1946), acq., 1947-1 Cum. Bull. 1.

[15] American Auto. Ass'n v. Commissioner, 19 T.C. 1146, 1159 (1953).

Further, the common interest must be more than a mere "sporting interest." For example, the American Kennel Club was denied an exemption because its membership was comprised of local organizations interested in promoting the sport of breeding dogs.[16] On the other hand, the Jockey Club, whose membership attempted to improve the business of horse racing and breeding, was found to have a common business purpose.[17] The third part of the definition excludes those organizations which claim a common interest but do nothing to improve conditions in a line of business. The American Automobile Association was denied the exemption because, *inter alia*, its main activities were not directed toward improving a line of business; instead, the court found that it was primarily engaged in rendering services to particular members.[18]

Although the definition of a business league has not presented much of a judicial problem, the prohibitions against business activity of a kind ordinarily carried on for profit and against performance of services for individual members have been the source of a great deal of litigation. These two conditions for exemption are necessary to assure that an organization which performs ordinary competitive functions does not obtain the tax exemption, and a resulting competitive advantage, by doing business on a cooperative basis and masquerading as a business league. For example, if the exemption were granted to an organization engaged in the ordinary and often necessary business activities of accumulating and disseminating credit information, such an organization could operate more economically than a nonexempt organization performing a similar service. In both instances, individual businessmen, rather than a line of business, receive the benefits of the service.

The courts have not construed the two conditions literally, but have developed a test, called the "incidental doctrine," which permits some business activity and services on the one hand and, on the other hand, limits their extent in order to prevent abuses. Thus, the exemption has been granted where either or both of these activities occur if they are not the *primary* activity in which the particular business league is engaged.[19] The courts determine whether the amount of business activity of a kind ordinarily carried on for profit, when compared to the business league's other activities, is sufficiently small so as not to constitute a primary activity. Similarly, if the amount of services rendered to individual members is not unduly greater than the number of activities designed to improve a line of business, then the

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[16] American Kennel Club, Inc. v. Hoey, 148 F.2d 920 (2d Cir. 1945).

[17] The Jockey Club v. United States, 135 Ct. Cl. 992, 137 F. Supp. 419 (1956) (exemption denied on other grounds).

[18] American Auto. Ass'n v. Commissioner, supra note 15, at 1159.

[19] The policy of permitting a business league to engage in incidental business activity was first announced by the Board of Tax Appeals in Waynesboro Mfrs. Ass'n, 1 B.T.A. 911 (1925). It is interesting to note that the Supreme Court originated the incidental doctrine to permit a religious institution to engage in commercial activities and still qualify for an income-tax exemption. The religious organization produced and sold wine and chocolates, but the Court found that these activities were "purely incidental [and] . . . financial gain [was] . . . not the end to which they are directed." Trinidad v. Sagrada Orden, 263 U.S. 578, 582 (1924).

services will be deemed incidental to the business league's total activities, and the exemption will not be denied. The test has been difficult to apply both because it is inherently vague and because the courts have not defined the permissible outer limits for business activity and services.

The incidental doctrine has produced another problem in the judicial application of section 501(c)(6). The statute prohibits the inurement of net earnings to the benefit of any private shareholder or individual. Profit distribution to individuals through dividends or any other direct means is clearly prohibited by this provision. The courts, however, have long realized that such earnings can inure in ways other than dividends.[20] For instance, assume that under the incidental doctrine a business league generates income by means of an incidental business and also renders incidental services to members. If the costs of the services so rendered are defrayed by the profits realized through the incidental business, then the price paid by the members for such services is reduced, and the profits of the business league have, to that extent, inured to the benefit of individual members.[21] A similar result obtains when services are provided to nonmembers at a higher cost than to members. The fact that services have been performed for nonmembers at a profit is evidence of a business of a kind ordinarily carried on for profit;[22] if this additional charge is used to reduce the cost to members, the prohibited inurement has occurred.[23] Thus, it seems that the incidental doctrine has permitted a loophole in the prohibition against the inurement of net earnings to any private shareholder or individual.

To close this loophole, the courts have carefully scrutinized the application of profits derived from incidental business activity. If these profits are applied solely to further and promote the interests of the line of business served by a business league, there is no reason to deny the exemption, despite the fact that some indirect or derivative benefits may accrue to individual members. If, on the other hand, the profits are applied to services performed for the direct benefit of individual members, and the cost of such services is thereby reduced, the proscription against inurement has been violated and the exemption will be denied.[24] This rule against the application of funds to direct services for members—the "application test"—is the method by which the courts have closed the loophole and thereby preserved the utility of the incidental doctrine.

In order to avoid possible complications with the provision against inurement of net earnings to individuals, a business league should provide services to members at a price equivalent to their market value.[25] It should be empha-

[20] See Northwestern Jobbers' Credit Bureau v. Commissioner, 37 F.2d 880 (8th Cir. 1930).

[21] Id. at 883.

[22] Fort Worth Grain & Cotton Exch. v. Commissioner, 27 B.T.A. 983, 985 (1933).

[23] Adjustment Bureau of St. Louis Ass'n of Credit Men v. Commissioner, 21 B.T.A. 232, 239 (1930).

[24] Northwestern Jobbers' Credit Bureau v. Commissioner, supra note 20, at 883.

[25] Northwestern Jobbers' Credit Bureau v. Commissioner, supra note 20; Durham Merchants' Ass'n v. United States, 34 F. Supp. 71 (M.D.N.C. 1940). In some cases it might be preferable for an exempt business league to relinquish its exemption. See

sized that *any* inurement of net profits is prohibited, and that the incidental test applies only to the amount of services a business league renders in proportion to its other activities. Even if the services are incidental, they must be *fully* compensated for by the recipient members.

It is submitted that the incidental test, as developed by the courts, successfully carries out the congressional mandate of section 501(c)(6). Congress intended that business leagues might engage in *some* profit-making activities; otherwise the prohibition against the inurement of net earnings would be meaningless. These profits encourage the formation of business leagues; participation by members is less onorous due to the reduced need for large contributions in the form of dues. In addition, these earnings permit business leagues to engage in additional desirable activities. Moreover, as long as the IRS polices the application of these funds, there is little danger of improper use for the benefit of individuals.

II. Application of the Doctrines

Discussion of the incidental doctrine and the proper-application test is difficult to comprehend in the abstract, because both relate to specific fact situations. For this reason, it is necessary to focus on the possible combinations of activities which involve the application of these doctrines and to examine some of the cases which have been decided. Of course, if an organization meets the literal definition of a business league and engages in neither of the activities proscribed by the regulation, all of its activities will necessarily be devoted to the improvement of conditions in the line of business which it was organized to serve. Such organizations present no judicial problems once they are identified as business leagues.

A. *Business Activities*

If a business league is organized for the specific purpose of accumulating profits rather than benefiting a line of business, section 501(c)(6) clearly disqualifies it from the exemption. If, however, a business league is not organized for profit and yet engages in some commercial activities which yield a profit, it still will not violate the requirements of either the statute or the regulation if the commercial activities are of a kind which other businesses *ordinarily* do not perform for profit. Thus, the incidental doctrine becomes operative only where the commercial activities are of the type proscribed by the statute—those of a kind *ordinarily* carried on for profit. For example, a trade show is a commercial activity which may or may not be a business of a kind ordinarily carried on for profit, depending upon the manner in which it is conducted, the nature of the business it represents, whether direct selling is permitted at the show, and whether admission fees are charged.[26] Similarly, publication of a magazine instructing shoe repairmen in new and better techniques was held to be a business not ordinarily carried on for profit despite the profits earned, because the magazine was intended

generally Webster, Should a Trade Association Give Up Tax Exemption? The Pros and Cons, 23 J. Taxation 358 (1965).

[26] Webster, op. cit. supra note 12, at 31 & n.73.

solely as a vehicle to advance the applicable line of business and was not of the type ordinarily published by a profit-oriented enterprise.[27]

Commercial activities such as supplying credit information,[28] operating a stock exchange,[29] cooperative buying and selling,[30] publishing trade manuals,[31] and advertising[32] are generally held to be activities of a kind ordinarily carried on for profit. In such cases the courts must apply the incidental doctrine and determine whether the ordinary business activity is a primary or merely an incidental purpose of the business league. Specific facts which are important in making such a determination are the proportion of the association's efforts devoted to such ordinary business activities (often gauged in terms of employee hours devoted to them)[33] and the amount of the total gross income thereby produced as compared to dues and other sources.[34] One credit association, for example, had four of its five employees working entirely for a credit-reporting service. This business was held to be a primary purpose of the organization, and the exemption was denied.[35] A similar organization was denied the exemption because approximately one-half of its employees were involved in credit-reporting.[36] One of the few credit associations which was exempted was found to be "chiefly educational" in that it instructed the public in the proper use of credit in general.[37] This last group did operate a credit-reporting bureau, but most of its income was derived from dues and there were no paid employees devoted to credit-reporting. On these facts, the ordinary business activity was held to be incidental.[38]

The cases involving publication of business literature provide another illustration of the judicial determination of the permissible degree of business activity. An automobile dealers' association published a used-car guide in competition with two other companies; the profits of the guide were used to cover deficits in other departments. Since this business activity provided a significant portion of the organization's income, it did not receive the exemption.[39] Also held nonexempt was an automotive association which published a catalogue listing the products of its members. In that case the court noted that a high percentage of employee time was devoted to this enterprise, and that sixty-nine per cent of the association's income was produced by the sale of the catalogue.[40]

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[27] National Leather & Shoe Finders Ass'n v. Commissioner, supra note 7.

[28] Durham Merchants' Ass'n v. United States, supra note 25.

[29] Produce Exch. Stock Clearing Ass'n v. Helvering, 71 F.2d 142 (2d Cir. 1934).

[30] Uniform Printing & Supply Co. v. Commissioner, 33 F.2d 445 (7th Cir.), cert. denied, 280 U.S. 591 (1929).

[31] National Auto. Dealers Ass'n v. Commissioner, 2 CCH Tax Ct. Mem. 291 (1943).

[32] Automotive Elec. Ass'n v. Commissioner, 168 F.2d 366 (6th Cir. 1948).

[33] Durham Merchants' Ass'n v. United States, supra note 25, at 73.

[34] Milwaukee Ass'n of Commerce v. United States, 72 F.2d 310, 311 (E.D. Wis. 1947).

[35] Durham Merchants' Ass'n v. United States, supra note 25, at 73.

[36] Credit Managers Ass'n v. Commissioner, 148 F.2d 41, 42 (9th Cir. 1945).

[37] Retail Credit Ass'n v. United States, supra note 9, at 857.

[38] Id. at 859.

[39] National Auto. Dealers Ass'n v. Commissioner, supra note 31, at 295.

[40] Automotive Elec. Ass'n v. Commissioner, supra note 32, at 368.

B. *Services to Individuals*

Treasury Regulation 1.501(c)(6)-1 provides that the activities of a business league "should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons." In order to apply this part of the regulation, the courts must distinguish between service to a line of business—a proper business-league function—and service to individuals—a proscribed activity. Only after a particular activity has been held to be a service to individuals does it become necessary to determine whether it is incidental or primary.

Washington State Apples, Inc. v. Commissioner illustrates how the courts determine whether a service benefits individuals or a line of business. The primary activity of the association was the cooperative advertising of State of Washington apples; the court held this to be a service to a line of business because

> no brand name or grower was mentioned in the advertisements, but only the varieties of apples grown in Washington. This type of advertisements [*sic*] did not replace individual advertising, but only increased the demand for Washington apples. The members and other growers benefited indirectly only by the increased demand for Washington apples.[41]

The decision indicates that the difference between a service to a line of business and a service to an individual is the way in which the service benefits competitors in the line of business. The Washington apple growers benefited indirectly by an increased demand for their product. Washington apples in general, not the apples of a single grower, were promoted. If the association had provided a service through which private apple growers could advertise their own products, it would have been held to be a service to individuals, because the members would have benefited directly as individual competitors.

Another example of the difference between services for individual persons and services to a line of business is provided by a comparison of two cases involving business leagues which conducted industry-wide trade shows as a primary activity. One association used its trade show as a means of acquainting interested persons with new techniques in the line of business generally; this activity was exempted.[42] The other association used its trade show to demonstrate the products of its individual members to the public, and permitted the solicitation and consummation of actual sales. On these facts the show was held to be a service for individual persons, and the exemption was withheld.[43]

If a court decides that a particular activity is a service for individuals, the incidental test becomes operative; the courts will only permit services

[41] 46 B.T.A. 64, 69 (1942).

[42] American Woodworking Mach. & Equip. Show, Inc. v. United States, supra note 8, at 398.

[43] National Ass'n of Display Indus., Inc. v. United States, 64-1 U.S. Tax Cas. ¶ 9285, at 91684 (S.D.N.Y. 1964).

for individuals which are incidental to the legitimate purposes and programs of the league.[44] Since the test is the same as that applied to business activities,[45] the cases under the preceding section apply equally here.

It should be noted that some activities may be both a service for individuals and business of a kind ordinarily carried on for profit.[46] Many businesses consist of industrial or commercial services for individuals. For example, a credit bureau is usually a business ordinarily carried on for profit and also a service to individual retailers. In such a case it does not matter which approach is taken: the incidental test is the same regardless of which condition for the exemption is in issue.

C. *"Line of Business": The Pepsi-Cola Problem*

One of the requirements of the regulation is that the activities of a business league must be directed to the improvement of business conditions in one or more lines of business, as distinguished from the performance of particular services for individual persons. The term "line of business" has never been expressly defined. It has been negatively defined in that an association's activities which are not services for individual persons, and not business activities of a kind ordinarily carried on for profit, have been assumed to be activities which promote a line of business. The statute and regulation have been applied with little difficulty even though the courts have not defined "a line of business." Recently, however, in *Pepsi Cola Bottlers' Ass'n v. United States*,[47] the Seventh Circuit Court of Appeals had occasion to consider the concept of a "line of business."

Membership in the Pepsi-Cola Bottlers' Association was limited to independent, franchised businesses engaged in the bottling and sale of Pepsi-Cola. By 1959, approximately eighty-three per cent of the Pepsi-Cola bottlers in the United States had joined the Association. It was organized "to promote, extend, further, protect, and improve the trade and business of bottling and selling Pepsi-Cola."[48] All of its income was derived from dues, assessed proportionately against its members on the basis of the amount of Pepsi-Cola concentrate purchased from the Pepsi-Cola Company each year. With the exception of certain bulletins, questionnaires, and reports offered to nonmember bottlers of Pepsi-Cola, the only activities engaged in by the Association were for the exclusive benefit of its members: dissemination of information about bookkeeping procedures and commonly used manufacturing techniques and equipment; training of management personnel; and a group insurance program.[49] The Association was organized despite the existence of a trade association which offered membership to and served all bottlers in the soft-drink industry. In addition, Pepsi-Cola bottlers do not

[44] Leaf Tobacco Exporters Ass'n v. Commissioner, 10 CCH Tax Ct. Mem. 706, 711 (1951).

[45] Webster, op. cit. supra note 12, at 18.

[46] General Contractors' Ass'n v. United States, 202 F.2d 633, 636 (7th Cir. 1953).

[47] 369 F.2d 250 (7th Cir. 1966).

[48] Id. at 251.

[49] Id. at 251-52; Pepsi-Cola Bottlers' Ass'n v. United States, 65-2 U.S. Tax Cas. ¶ 9705, at 96905 (N.D. Ill. 1965).

compete with each other; their sales territories are precisely defined by the Pepsi-Cola Company and do not overlap.

The Commissioner of Internal Revenue refused to allow the business-league exemption and denied the Association's request for a refund of the income taxes paid by it for 1959. The district court held that the Association was entitled to this exemption.[50] On appeal to the Seventh Circuit, the government argued that the Association did not serve a line of business, *i.e.*, the entire soft-drink industry. The majority, although not expressly holding that the bottling and selling of Pepsi-Cola was a line of business, impliedly did so by holding that the Association was entitled to the exemption: "The plaintiff Association cannot be disqualified merely because its members all bottle a particular soft drink product."[51]

In reaching its decision, the majority in *Pepsi-Cola* found that the Association rendered no services for individual bottlers or limited groups of bottlers. It is unclear whether the majority found that the Association rendered no *services* at all, or that the services which were rendered were made available to all of the Association's members. It is unimportant to decide which of these alternatives was intended, because the regulation requires activities which improve conditions in a line of business and proscribes activities which only benefit the members of the organization. Since the Pepsi-Cola Association's activities were confined to rendering particular services for its members, and membership was restricted to bottlers and sellers of Pepsi-Cola, the Association did not serve a "line" of business but only one competitor in the whole soft-drink industry.

Judge Kiley, dissenting, stated that bottling Pepsi-Cola was not a line of business, but only one of many businesses competing in the soft-drink industry:

> [T]he services rendered by the Association to its members are not incidental to a general purpose of improving business conditions. They are essential to an express general purpose, the improvement of the members' competitive position as against nonmembers.[52]

Thus, according to the dissent, the lack of competition among the members of the Association limited the effect of its activities to the improvement of their own competitive position in the soft-drink industry. Consequently, the effect of the Association's activities did not improve business conditions generally, as is required by the regulation.

The dissenting opinion is supported by prior case law and by rulings of the Internal Revenue Service. One noted writer has observed that

> in all of the administratively and judicially approved trade associations [including business leagues] the organization involved was composed of businessmen or business representatives in a competitive relationship with one another . . . who joined together

[50] Id. at 96906.
[51] 369 F.2d at 252.
[52] Id. at 253.

> to improve business conditions generally while still maintaining the competitive relationship.[53]

In Revenue Ruling 58-294[54] the IRS denied the exemption to a similar association whose membership was confined to businesses licensed to manufacture and sell a patented product. It was held that the organization was "engaged in furthering the business interests of the dealers in the particular patented product, rather than the improvement of business conditions of one or more lines of business. . . ."

It is submitted that when membership in an association is limited to businesses engaged in the manufacturing and/or distribution of a brand-name product which competes with other brand-name products, any of the association's activities, other than business activities of a kind ordinarily carried on for profit, will necessarily directly benefit its members, because they will improve their competitive position with respect to nonmember competitors. Since association activities which confer a direct benefit on members are considered "services to individuals" and not "activities designed to improve business conditions generally," the incidental doctrine becomes operative, and the exemption should be denied if the association engages *primarily* in activities which directly benefit its members. In *Pepsi-Cola*, all of the Association's activities conferred direct benefits on its members, and none of these activities were made available to competing bottlers of other soft drinks; the effect of the Association's activities was improvement of the members' business methods and lowering of their business costs—*i.e.*, an over-all improvement of their competitive position. Therefore, the Association was primarily a "service" organization, and the exemption should have been denied on this ground; such a holding would have made it unnecessary to determine whether the Association served a line of business.

Prior to *Pepsi-Cola*, the courts applied the statute and regulation with little difficulty. This case, however, illustrates the confusion that can arise when a court attempts to define a "line of business" in a borderline situation. It is suggested that such confusion can be avoided by instead determining whether the particular association seeking exemption is primarily a service organization. This determination should be based on an appraisal of its competitive position in the relevant market and, if membership is restricted, on whether participation in its activities is made available to nonmember competitors.

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[53] Webster, op. cit. supra note 12, at 6.
[54] 1958-1 Cum. Bull. 244.