



# Exempt Organizations Technical Guide

## TG 48: Unrelated Business Income Tax

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**Technical Guide Revision Date: 12/15/2023**

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## I. Overview

- (1) This guide provides information on unrelated business income (UBI) and unrelated business income tax (UBIT). The unrelated business income tax provisions are found in Sections 511 through 515.
  - a. Section 511, Imposition of tax on unrelated business income of charitable, etc., organizations.
  - b. Section 512, Unrelated business taxable income.
  - c. Section 513, Unrelated trade or business.
  - d. Section 514, Unrelated debt-financed income.
  - e. Section 515, Taxes of foreign countries and possessions of the United States.

## A. Background

- (1) Section 511 imposed a tax on the unrelated business taxable income as defined by Section 512 of certain otherwise tax-exempt organizations.
- (2) The IRS will generally determine an organization to be tax exempt only if its primary purpose is to engage in the type of activity prescribed in the code Section (for example, Sections 501 or 521) under which it claims exemption.
- (3) An organization isn't generally determined to be exempt if its primary purpose is conducting a business of a type ordinarily carried on for profit, and not the furtherance of an exempt purpose. See, for example, Section 502. If, however, the business activity is subservient or secondary to the organization's exempt purpose and functions, exemption may or may not be established. The determination depends on whether the specific statutory provision under which exemption is sought precludes operation of a trade or business.
- (4) Many exempt organizations operate trades or businesses which further their exempt purposes. Others operate trades or businesses which have little or no relationship to their exempt purposes aside from the need for funds to carry out exempt purposes.
- (5) Publication 598, Tax on Unrelated Business Income of Exempt Organizations, gives a detailed description of Section 511 through 514.
- (6) Publication 1828, Tax Guide for Churches and Religious Organizations, includes a brief, plain-language explanation of how the unrelated provisions apply to churches and religious organizations.

## B. Relevant Terms

- (1) **Unrelated business taxable income** is the gross income derived by any tax-exempt organization from any unrelated trade or business (as defined in Section 513) regularly carried on by it with certain modifications and deductions

set forth in Section 512. See Section 512(a)(1). See Part III of this document for further discussion.

- (2) **Trade or business** for purposes of Section 513, has the same meaning as it has in Section 162. It generally includes any activity carried on for the production of income from the sale of goods or performance of services. See Treasury Regulations (Treas. Reg.) 1.513-1(b). See Part II.A of this document.
- (3) **Substantially related:** Generally, gross income derives from an "unrelated trade or business" within the meaning of Section 513(a) if the conduct of the trade or business which produces the income isn't 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 generating the income in question and the accomplishment of the organization's exempt purposes. 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 Section 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. See Treas. Reg. 1.513-1(d)(1). See Part II.C of this document for further discussion.
- (4) **Regularly carried on:** Business activities of an exempt organization are regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations. See Treas. Reg. 1.513-1(c). See Part II.B of this document.
- (5) **Debt-financed property**, as defined in Section 514(b), means any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition) See Part V. of this document. The exceptions to this rule are discussed in Part V.H. of this document. See also Section 514(b) and Treas. Reg. 1.514(b)-1.
- (6) **Acquisition indebtedness** is defined in Section 514(c), with respect to any debt-financed property, as the unpaid amount of:
  - a. The indebtedness incurred by the organization in acquiring or improving such property (see Section 514(c)(1)(A)),
  - b. The indebtedness incurred before the acquisition or improvement of such property if such indebtedness wouldn't have been incurred but for such acquisition or improvement (see Section 514(c)(1)(B)), and

- c. The indebtedness incurred after the acquisition or improvement of such property if such indebtedness wouldn't have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement. See Section 514(c)(1)(C) and Treas. Reg. 1.514(c)-1. See also Part V.F. of this document for further discussion.

## C. Legislative History

- (1) Prior to the Revenue Act of 1950, which added what are now Sections 511 through 515, there was no unrelated business income tax. An organization was either fully tax exempt or fully taxable on all its income. If an exempt organization wasn't primarily engaged in an exempt activity, revocation of exempt status was the only remedy.
  - a. Unrelated trade or business activities didn't exist because courts had ruled that the use or destination of income generated, rather than the income's source, was the primary factor in determining whether the income was taxable. If income from an activity was used in activities furthering the organization's exempt purpose, the income was considered tax exempt. The courts referred to this as the "destination of income" test. The "destination of income test" was laid down by the United States Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924), holding that the destination and not the source of the income was the ultimate test of exemption.
  - b. Another problem was that many of the organizations exempt under the 1939 Code weren't required to file information returns, therefore the IRS was often unaware of the business activities in which such organizations participated. See also *People's Educational Camp Soc. Inc. v. C.I.R.* 331 F.2d 923 (1964) holding that "destination of income test" didn't afford income tax exemption to corporation which devoted much of its revenues to improving its ability to compete commercially through accumulation of large surpluses and expansion of its income producing facilities.
- (2) By 1950, Congress had become concerned that some exempt organizations were engaged in profitable business activities in competition with taxable entities. See *Congressional Record*, Vol. 96, Part 7, pp. 9273–9274.
- (3) These problems were, for the most part, resolved by the Revenue Act of 1950 which, among other things, imposed a tax on the "unrelated business taxable income" of certain otherwise tax-exempt organizations. In addition, most exempt organizations are now required to file annual information returns, making it easier to scrutinize their operations to determine whether they continue to be entitled to exemption and, if so, whether they are subject to the tax on UBI.
- (4) According to the report of the Senate Finance Committee (S. Rep. No. 2375, 81st Cong., 2d Sess. 27 (1950), 1950-2 C.B. 483, 504):

- a. "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of IRC Section (501) organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it in installments out of subsequent earnings - a procedure which usually couldn't be followed if the business were taxable."
- (5) The Revenue Act of 1950 excepted certain organizations from the UBIT provisions. However, it became apparent that many of the excepted organizations were engaging, or were apt to engage, in unrelated business. Congress responded in the Tax Reform Act of 1969 by subjecting almost all exempt organizations to the tax on unrelated business income. In addition, changes were made to expand or redefine the types of income subject to the unrelated provisions in order to eliminate tax avoidance and abuses. These changes included:
  - a. The unrelated debt-financed income provisions. See Section 514(a)-514(f).
  - b. A more restrictive exclusion in the case of rents. See Section 512(b)(3).
  - c. Conditions under which a controlling organization includes in unrelated business taxable income interest, annuities, royalties, and rents it receives or accrues from a controlled entity. See Section 512(b)(13).
- (6) In 2017, Public Law 115-97, 131 Stat. 2054, Section 13702 (Dec. 22, 2017) established that for taxable years beginning after December 31, 2017, organizations with more than one unrelated trade or business must calculate unrelated business taxable income separately with respect to each trade or business (Section 512(a)(6)). This provision addresses the perception, as discussed in *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990), that organizations were creating taxable losses from activities that aren't trades or businesses "because they lacked a profit motive" to offset unrelated business taxable income generated by other activities. Further, Congress intended "that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year." See H.R. Rep. No. 115-466, at 548 (2017). Final regulations on Section 512(a)(6) were published on December 2, 2020.

## **D. Organizations Subject to Tax**

- (1) The tax on unrelated business income applies to all organizations exempt from taxation under Section 501(a) (except United States instrumentalities described in Section 501(c)(1)) or trusts described in Section 401(a)) plus state colleges, municipal colleges and universities. See Section 511(a)(2). In addition, there

are special rules for taxing the unrelated business income of title-holding corporations described in Section 501(c)(2). See Section 511(c).

## **D.1. Taxation of Churches**

- (1) Prior to the Tax Reform Act of 1969, churches weren't subject to the unrelated business income tax provisions. However, churches were involved in various types of commercial activities, such as operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, and restaurants. Congress sought to end this preferential treatment for churches.
- (2) The Tax Reform Act of 1969 made income derived by churches and conventions or associations of churches subject to the taxes imposed by Section 511. See Treas. Reg. 1.511-2(a)(3)(iii). Treas. Reg. 1.511-2(a)(3)(ii) provides the following description of what constitutes a church or convention of churches for purposes of Section 511:
  - a. The term church includes a religious order or a religious organization if such order or organization is:
    - An integral part of a church, and
    - Engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise.
  - b. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the ministration of sacerdotal functions and the conduct of religious worship. If a religious order or organization isn't an integral part of a church, or if such an order or organization isn't authorized to carry out the functions of a church (ministration of sacerdotal functions and conduct of religious worship) then it is subject to the tax imposed by Section 511 whether or not it engages in religious, educational, or charitable activities approved by a church.
  - c. What constitutes the conduct of religious worship, or the ministration of sacerdotal functions depends on the tenets and practices of a particular religious body constituting a church.
- (3) Revenue Ruling (Rev. Rul.) 77-290, 1977-2 C.B. 26, holds, in part, that where a member of a religious order receives income as an agent of the order and, pursuant to a vow of poverty, remits the income to the order, such income is the income of the order and not of the member. In such cases the tax imposed by Section 511 may be applicable to the income of the order.

## **D.2. State and Municipal Colleges**

- (1) The tax on unrelated business income didn't apply to state and municipally owned institutions of higher learning under the Revenue Act of 1950. The

Revenue Act of 1951, however, remedied this omission by providing that state and municipal colleges and universities are subject to unrelated business income in the same manner as other colleges and universities which are tax-exempt under Section 501(c)(3). See Section 511(a)(2)(B) and Treas. Reg. 1.511-2(a)(2).

- (2) The UBIT is imposed not only on universities and colleges themselves, but also on any wholly owned subsidiaries. See Section 511(a)(2)(B) and Treas. Reg. 1.511-2(a)(2).
- (3) Section 7871(a)(5) provides that an Indian tribal government shall be treated as a state for purposes of Section 511(a)(2)(B). Consequently, any college or university owned by an Indian tribal government is subject to the same treatment with respect to unrelated business income as state and municipally owned colleges and universities. Section 7871(a)(5) is effective for taxable years beginning after December 31, 1982. See also Treas. Reg. 305.7871-1(a)(3).

### **D.3. Special Rules for Title Holding Companies**

- (1) Section 511(c) provides that an exempt title holding company, described in Section 501(c)(2), is treated as being organized and operated for the same purposes as the exempt payee organization, as well as for its title-holding purpose if it both pays any amount of its net income to an organization exempt from taxation under Section 501(a) (or would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and it files a consolidated return with that organization. See Sections 1501 and 1504(e) and Treas. Reg. 1.511-2(c). Therefore, if the source of income of a title holding company is related to the exempt functions of the exempt payee organization, the income won't be subject to tax provided the holding company and the payee organization file a consolidated return on Form 990-T.
  - a. For example, assume that the income of X, a Section 501(c)(2) corporation, is required to be distributed to exempt organization A. During the taxable year, X realizes net income of \$900,000 from source M and \$100,000 from source N. Source M is related to A's exempt function, while source N isn't related. X and A file a consolidated return for such taxable year. X has net unrelated business income of \$100,000 subject to the modifications in Section 512(b).

## **II. Unrelated Trade or Business**

- (1) Exempt organizations are required to include in unrelated business taxable income "the gross income derived by any organization from any unrelated trade or business (as defined in Section 513) regularly carried on by it less deductions allowed that are directly connected with the carrying on of such trade or business, in both cases computed with the modifications provided in

Section 512(b).” The following three conditions generally must be met per Section 513 and Treas. Reg. 1.513-1(a) before income from an activity may be classified as unrelated trade or business income:

- a. The income is from a trade or business,
  - b. The trade or business is regularly carried on by the organization, and
  - c. The conduct of such trade or business isn’t substantially related (other than through the production of funds) to the organization’s performance of its exempt functions.
- (2) Section 512 includes certain modifications to this general definition. See Part VI of this document.

## **A. Trade or Business**

- (1) For purposes of Section 513, the term "trade or business" has the same meaning as it has in Section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. See Section 513(c) and Treas. Reg. 1.513-1(b).
- (2) The standard test for whether an activity constitutes a trade or business for purposes of Section 162 is whether the activity “was entered into with the dominant hope and intent of realizing a profit.” See *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) (quoting *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)).
- (3) A profit motive requires “an intent to generate receipts in excess of costs.” *Portland Golf Club v. Commissioner*, 497 U.S. 154, 166 (1990).

### **A.1. Profit Motive**

- (1) Per Section 512, exempt organizations in determining unrelated business taxable income (UBTI) may deduct expenses directly connected with the production of gross income (other than exempt function income) to the extent such deductions are otherwise allowed by Chapter 1 of the Code. In general, the Chapter 1 deduction provision Section 162 provides for a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Generally, an activity lacking a profit motivation, doesn’t constitute a trade or business for purposes of the deduction of expenses under Section 162.
- (2) In *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990), the Court held that a Section 501(c)(7) social club was required to demonstrate an intent to profit. The Court analyzed Section 512(a)(3)(A) and viewed the inclusion of the phrase "allowed by this chapter" as limiting deductions to Chapter 1. The expenses at issue were allowable as deductions (if at all) only under Section 162. Under Section 162(a), expenses must be incurred in connection with a "trade or business." The Court, citing *Commissioner v. Groetzinger*, 480 U.S.



23, 35 (1987), stated that trade or business activities fall within the scope of Section 162(a) only if an intent to profit has been shown.

## **A.2. Trade or Business Carried on Within a Larger Aggregate of Other Activities (Fragmentation Rule)**

- (1) The term “trade or business” isn’t limited to integrated aggregates of assets, activities, and goodwill which comprise businesses for the purposes of certain other provisions of the Code. Generally, activities of producing or distributing goods or performing services from which a particular amount of gross income is derived won’t lose identity as trade or business merely because they are 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. See Section 513(c) and Treas. Reg. 1.513-1(b). This is commonly known as the “fragmentation rule.”
- (2) Where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it doesn’t result in profit. See Section 513(c) and Treas. Reg. 1.513-1(b). Activities classified as unrelated business are also subject to siloing into separate unrelated trades or businesses for purposes of Section 512(a)(6) (discussed in Part III.G of this document).
- (3) The fragmentation rule initially appeared as a regulation in 1967, directed partly to periodical advertising. In 1969, Congress affirmed this treatment of advertising and similar activities carried on for the production of income as unrelated trade or business subject to tax even though advertising, for example, may appear in a periodical related to the exempt purposes of an organization. Section 513(c); H.R. Rep. No. 91–413 (Part 1), 91st Cong., 1st Sess. 45 (1969), 1969–3 C.B. 229.
- (4) In *United States v. American College of Physicians*, 475 U.S. 834 (1986), the court held that when an exempt organization publishes a periodical containing articles and editorials pertaining to its exempt purpose, the sale of advertising in the publications is an unrelated trade or business if the conduct of the advertising business doesn’t contribute importantly to the organization’s exempt purposes (which it didn’t under the facts of the case). The particular purpose behind the enactment of Section 513(c) and Treas. Reg. 1.513-1(b) is to “fragment” out unrelated business activity (in this case the advertising portion of the periodical, not substantially related) from related business or other exempt-function activity (the educational or editorial portion of the periodical), for purposes of unrelated trade or business.
- (5) The fragmentation rule may apply to separate out or “fragment,” as a separate trade or business, sales to non-members from sales to members that are excepted from unrelated business under the convenience exception of Section



513(a)(2), where the sales to non-members aren't merely casual but regularly carried on.

- a. For example, in Rev. Rul. 68-374 (discussed in Part II.B.3 of this document) the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy didn't lose identity as an unrelated trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes.
  - b. See also Rev. Rul. 78-98, 1978-1 C.B. 167 (public use of school's ski facility was unrelated business but use by students wasn't).
- (6) Similarly, sales of a particular line of merchandise may be considered separately to determine their relatedness to the exempt purpose, and thus "fragmented" between related and unrelated business.
- a. For example, in Rev. Rul. 73-105, 1973-1 C.B. 264, the sale of scientific books and city souvenirs by a museum of folk-art exempt from tax under Section 501(c)(3) constituted unrelated trade or business even though other items sold in the museum shop are related to its exempt function.

### **A.3. Insurance Activities**

- (1) Exempt organizations often arrange for the provision of insurance benefits to their members for a fee. In some cases, this activity may be an exempt function (for example, Section 501(c)(8) fraternal organizations and Section 501(c)(9) VEBAs). In other cases, it may constitute unrelated business.
- (2) In *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court held that a Section 501(c)(3) organization's insurance program constituted both the sale of goods and the performance of services and, therefore, was a trade or business for purposes of the tax on unrelated business income.
  - a. American Bar Endowment (ABE) was the group policyholder and administrator of insurance policies offering life, disability, and medical coverage.
  - b. ABE negotiated premium rates with insurers and selected which insurer would provide coverage.
  - c. It compiled a list of its members, solicited their insurance business, collected premiums, transmitted premiums to the insurer, maintained files on each policyholder, answered members' questions concerning insurance policies, and screened claims for benefits.
  - d. Insured members were required to agree that all dividends refunded by the insurer will be paid to ABE to further its charitable and educational activities.

- e. The Court stated that assembling a group of better than average insurance risks, negotiating on their behalf with insurance companies, and administering a group policy are activities engaged in by private commercial entities in order to make a profit.
  - f. In addition to concluding that amounts derived from the insurance activities were unrelated business taxable income, the Court also concluded that none of the individuals insured had established that any portion of their premium payments constituted a charitable deduction.
- (3) Similar insurance activities of organizations described in Section 501(c)(6) have also been held to constitute unrelated trade or business. See:
- a. Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, 801 F. 2d 987 (7th Cir. 1986)
  - b. Professional Insurance Agents of Michigan v. Commissioner, 726 F. 2d 1097 (6th Cir. 1984)
  - c. Carolinas Farm & Power Equipment Dealers Ass'n v. United States, 699 F. 2d 167 (4th Cir. 1983)
  - d. Louisiana Credit Union League v. United States, 693 F. 2d 525 (5th Cir. 1982)
- (4) However, in Independent Insurance Agents of Northern Nevada, Inc. v. United States, 44 AFTR 2d 79-5880, 79-2 USTC 9601 (D. Nev. 1979), the court held that income realized from managing the insurance needs of tax-supported public agencies was related to the tax-exempt purpose of a business league under Section 501(c)(6). In this case, the organization acted as an insurance broker on behalf of a city, a county, a public school district, a fire department, a fair and recreational board, and a public hospital. The IRS didn't acquiesce in this decision. See IRS AOD-1980-117 (September 28, 1979) and IRS AOD-1981-108 (April 30, 1981).

#### **A.4. Competition**

- (1) Although the legislative history reflects that the primary objective of adopting the UBIT was to eliminate a source of unfair competition by placing the unrelated business activities of exempt organizations on equal footing with taxable businesses (see Treas. Reg. 1.513-1(b); S. Rep. No. 2375, 81st Cong., 2d Sess. 27 (1950), 1950-2 C.B. 483, 504)), the IRS maintains that unfair competition is neither the sole nor the primary criterion to be considered in determining whether an activity is unrelated trade or business.
- a. The Code and regulations do not require the IRS to consider competition in determining UBIT.
  - b. Also, IRS forms do not require information reporting concerning competition.

- c. Additionally, the IRS lacks both the data and the expertise to determine the degree of competition and most particularly whether there is “unfair” competition. See testimony of Lawrence B. Gibbs, Commissioner of Internal Revenue, before the Subcommittee on Oversight, House Ways and Means Committee, on June 22, 1987, 100th Cong., 1st Sess., Pt. 1 of 3, US GPO Serial 100-26, p. 69.
  - d. Although preventing unfair competition is the major purpose of the unrelated business income tax, a specific finding of unfair competition isn’t always required to determine which activities constitute a trade or business. See *Fraternal Order of Police v. Commissioner*, 833 F.2d 717, 722 (7th Cir. 1987).
- (2) Notwithstanding that view, some courts have used the presence of unfair competition as part of the test for whether an activity is a trade or business. The issue was repeatedly raised in greeting card cases discussed below (see also the low-cost article discussion in Part VII.I of this document):
- a. In *Hope School v. United States*, 612 F. 2d 298 (7th Cir. 1980), the court strongly endorsed the concept of unfair competition as an essential element in the analysis of unrelated business taxable income. However, there was no evidence presented at trial to suggest that the school’s solicitation program using mailed greetings cards represented the possibility of an unfair competitive advantage over taxpaying greeting card businesses. Therefore, the court found no unfair competition.
  - b. Similarly, in *Veterans of Foreign Wars of the United States v. United States*, 601 F. Supp. 7 (W.D. Mo. 1984), the court cited *Hope School* and found that the organization, which ran a greeting card solicitation program but didn’t reinvest the proceeds from its campaign back into the program, gained no competitive advantage from its tax-exempt status and didn’t operate a trade or business for purposes of the tax on unrelated business income.
  - c. Another case in which the absence of competition was emphasized is *Greene County Medical Society Foundation v. United States*, 345 F. Supp. 900 (W.D. Mo. 1972). There, the court stated that the organization’s production and sale of phonograph records by the “Singing Doctors” wasn’t competitive with the ordinary business of commercial record production and sales and, therefore, wasn’t a trade or business. The IRS didn’t acquiesce in this decision. See IRS AOD-1973 WL 34820 (May 16, 1973) and IRS AOD-1973 WL 34826 (May 21, 1973).
  - d. The Tax Court in *Veterans of Foreign Wars, Department of Michigan v. Commissioner*, 89 T.C. 7 (1987), found that the organization’s Christmas card program was in direct competition with Christmas cards marketed by commercial entities.
  - e. In *Disabled American Veterans v. United States*, 650 F. 2d 1178 (Ct. Cl. 1981), the court stated that the legislative history clearly indicates that to

constitute a trade or business for UBTI purposes, the activity must be conducted in a competitive fashion. The court clarified its position by stating that actual competition need not be established, since Sections 511–513 don't confine UBTI to those situations where it is established that some specific aspect of unfair competition has occurred.

- f. In *Smith-Dodd Businessman's Association, Inc. v. Commissioner*, 65 T.C. 620 (1975), the Tax Court stated that "unfair competition plays a relatively insignificant role in the application of the amended unrelated business tax."
- (3) A few courts have tried to reconcile the profit motive test and unfair competition test by observing that they aren't in conflict. See, for example, *Illinois Association of Professional Insurance Agents v. Commissioner*, 801 F.2d 987, 991 n.4 (7th Cir. 1986) ("No court has yet created a general exception to the unrelated business income tax based solely on a showing that the tax-exempt organization didn't compete, or threaten to compete, unfairly with tax-paying entities"). Courts, especially in the wake of *American Bar Endowment*, are more likely to apply the profit motive test. See *National Water Well Association v. Commissioner*, 92 T.C. 75, 85-86 (1989).
- (4) Strong support for the IRS position that competition is neither the sole nor primary criterion to be considered in determining whether an activity is unrelated trade or business can be found in *Clarence LaBelle Post No. 217, Veterans of Foreign Wars of the United States v. United States*, 580 F. 2d 270 (8th Cir. 1978). In that case, the organization argued that it should not be subject to UBIT because it wasn't competing with a taxpaying entity, while the government argued that UBIT isn't limited to competitive businesses. The court held that UBIT isn't limited to income earned by a trade or business that operates in competition with taxpaying entities. See also *Bartels Trust for Benefit of Cornell University ex rel. Bartels v. United States*, 617 F. 3d 1357 (Fed. Cir. 2010). See also *Education Athletic Association v. Commissioner*, T.C. Memo 1999-75 (holding that the fact that the taxpayer didn't compete with for-profit entities with respect to pickle card sales wasn't controlling for purposes of determining whether income from such sales was subject to UBIT).

## B. Regularly Carried On

- (1) Section 512(a)(1) defines unrelated business taxable income and provides the general rule that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in Section 513) regularly carried on by it, less allowable deductions and also taking into account the modifications provided in Section 512(b).

### B.1. General

- (1) In determining whether a trade or business from which a particular amount of gross income derives is "regularly carried on" within the meaning of Section 512, regard must be made to the frequency and continuity with which the

activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of UBIT's purpose to place exempt organizations' business activities upon the same tax basis as the nonexempt business endeavors with which they compete. So, for example, specific business activities of an exempt organization are ordinarily deemed to be "regularly carried on" if they manifest a frequency and continuity and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations. See Treas. Reg. 1.513-1(c)(1).

## **B.2. Normal Time Span of Activities**

- (1) Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks doesn't constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only two weeks at a state fair wouldn't be the regular conduct of trade or business. See Treas. Reg. 1.513-1(c)(2)(i).
- (2) However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. For example, the operation of a commercial parking lot on Saturday of each week year-round would be the regular conduct of trade or business. See Treas. Reg. 1.513-1(c)(2)(i).
- (3) Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of these activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season. See Treas. Reg. 1.513-1(c)(2)(i).
- (4) The following revenue rulings show how the time span of certain activities affect whether those activities are viewed as regularly carried on:
  - a. The sale of advertising during a four-month period by the paid employees of an exempt organization, which raises funds for an exempt symphony orchestra and publishes a weekly concert program distributed free at the symphony performances over an eight-month period, is a business regularly carried on in determining unrelated income under Section 512. See Rev. Rul. 75-200, 1975-1 C.B.163.
  - b. However, the sale of advertising by volunteers of an exempt organization, which raises funds for an exempt symphony orchestra and publishes an annual concert book distributed at the orchestra's annual charity ball, isn't a business regularly carried on in determining unrelated income under

Section 512. See Rev. Rul. 75-201, 1975-1 C.B. 164. See also Treas. Reg. 1.513-1(c)(2)(ii) and (iii).

- c. A two-week horse racing meet featuring pari-mutuel betting conducted by a Section 501(c)(3) county fair association is a regularly carried on trade or business, because it is usual to carry on such trade or business only during a particular season. See Rev. Rul. 68-505, 1968-2 C.B. 248.

### **B.3. Intermittent Activities**

- (1) In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities, which are engaged in only discontinuously or periodically, won't be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. See Treas. Reg. 1.513-1(c)(2)(ii). Below are a couple of examples.
  - a. The publication of advertising in programs for sports events, music or drama performances won't ordinarily be deemed to be the regular carrying on of business. See Treas. Reg. 1.513-1(c)(2)(ii).
  - b. However, income an exempt organization derives from the sale of advertising in its annual yearbook is unrelated business taxable income where an independent commercial firm under a contract covering a full calendar year conducts an intensive advertising solicitation campaign in the organization's name and is paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook. Although the publication is distributed only annually, the advertising solicitation requires that a significant span of time be devoted to these activities. By engaging in an extensive campaign of advertising solicitation, the organization is conducting competitive and promotional efforts typical of commercial endeavors. So, the activities manifest a frequency and continuity and are pursued in a manner not materially different from similar commercial activities. See Rev. Rul. 73-424, 1973-2 C.B. 190.
  - c. Similarly, *National Collegiate Athletic Association v. Commissioner*, 92 T.C. 456 (1989), held that income from advertising during the NCAA March basketball tournament was UBTI because the taxpayer failed to show that sales of the ads (part of the business of advertising) weren't regularly carried on. The Court of Appeals reversed, holding that the display of the advertising during the tournament was the only relevant time period (914 F.2d 1417 (10th Cir. 1990).) The IRS didn't acquiesce in the decision (IRS AOD-1991-015 (September 20, 1990)). *State Police Association of Massachusetts v. Commissioner*, T.C. Memo. 1996-407, aff'd, 125 F.3d 1 (1st Cir. 1997), reasoned that the holding in *NCAA* for advertising in an event program didn't apply to advertising in an annual

yearbook. An issue in some cases is whether a contractor is acting as the exempt organization's agent in conducting publishing and advertising activities, if not, the contractor's activity might not be taken into account in determining whether EO "regularly carries on" the activity, as well as whether payments to the exempt organization from the contractor are properly characterized as royalties or the proceeds of unrelated business activities conducted on the exempt organization's behalf. See the discussion in Part VI.A.2(9) of this document.

- (2) In *Suffolk County Patrolmen's Benevolent Association, Inc. v. Commissioner*, 77 T.C. 1314 (1981), acquiesced by the IRS in 1984-2 C.B. 1 (see IRS AOD-1984-20 (March 22, 1984)), an organization entered into contracts with a professional promoter for the production of annual fundraising events, which consisted of the presentation and sponsoring of professional vaudeville entertainment shows and the sale of advertising in a program guide. These shows were held during one weekend per year over the course of a few years. The court examined the relevant legislative history, regulations, and revenue rulings and found that the annual vaudeville show, and sale of advertising was merely an intermittent activity to which Congress didn't intend the tax on unrelated business income to apply. The court noted that the organization's advertising activities were "almost identical" to the example in Treas. Reg. 1.513-1(c)(2)(ii), which states that the publication of advertising in programs for sports events or music or drama performances ordinarily isn't "regularly carried on." Therefore, the court held that the organization's activities weren't conducted with sufficient frequency and continuity, or in such manner, to be regarded as having been "regularly carried on."
- (3) Treas. Reg. 1.513-1(c)(2)(ii) also states that where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or "primarily for the convenience" of those persons per Section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which don't qualify as related to the exempt function involved or as described in Section 513(a)(2) aren't treated as regularly carried on. However, where the nonqualifying sales aren't merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the requirement of regularity under Section 512.
- (4) Rev. Rul. 68-374, 1968-2 C.B. 242, presents two contrasting situations to illustrate the meaning of casual sales:
  - a. An exempt hospital maintains a pharmacy on its main floor primarily for the use of its patients. The pharmacy is also open to the general public, and frequent and continuous sales are made to nonpatients. Sales to the public aren't primarily for the convenience of the patients of the hospital within the meaning of Section 513(a)(2). There is no substantial causal relationship between the achievement of the hospital's exempt purpose



and the general public's purchases. Therefore, this activity constitutes unrelated trade or business within the meaning of Section 513.

- b. The hospital pharmacy is closed to the general public but may occasionally fill prescriptions for private patients (who aren't hospital patients) of its staff doctors. The Rev. Rul. states that under these circumstances such sales would constitute unrelated trade or business. However, these nonqualifying sales are considered casual sales (see Treas. Reg. 1.513-1(c)(2)(ii)) because of the manner in which they are conducted. Therefore, the sales activity isn't considered regularly carried on and income derived from these sales doesn't constitute UBT.

#### **B.4. Special Rule in Certain Cases of Infrequent Conduct**

- (1) The regulations provide a special rule for certain intermittent income producing activities that occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. See Treas. Reg. 1.513-1(c)(2)(iii). The regulations say that income producing or fundraising activities lasting only a short period of time aren't ordinarily treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, these activities aren't regarded as regularly carried on merely because they're conducted every year.
  - a. For example, an annual dance or similar fundraising event for charity wouldn't be regularly carried on merely because it is conducted every year on a recurrent basis.
  - b. Rev. Rul. 75-201, 1975-1 C.B. 164, presents another example of this type of infrequent activity. See Part II.B.2.(4) of this document.

#### **C. Substantially Related**

- (1) A trade or business is considered unrelated if its conduct isn't substantially related (other than through the production of funds) to the exercise or performance of an organization's exempt purpose. See Section 513(a).
- (2) To determine whether a business activity is or isn't substantially related requires an examination of the relationship between the business activities which generate the particular income in question—that is, the activities of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purpose. To be related, the relationship must be causal. In addition, the causal relationship must be a substantial one. So, the activities which generate the income must *contribute importantly* to the accomplishment of the organization's exempt purposes to be substantially related. See Treas. Reg. 1.513-1(d)(1) & (2).
- (3) A particular business activity may be substantially related for one Section 501(c)(3) organization and unrelated for another, depending on the purposes of the particular organization. See, for example, Rev. Rul. 73-105, discussed in Part II.C.4.(2) below. But in the case of a state university or other organization



described in Section 511(a)(2)(B), a business activity isn't unrelated business if it is substantially related to any purpose or function described in Section 501(c)(3). See Section 513(a).

- (4) Where income is realized from activities that are conducted on a larger scale than is reasonably necessary for the performance of an exempt function, the income attributable to the excess constitutes gross income from the conduct of unrelated trade or business. See Treas. Reg. 1.513-1(d)(3).
- (5) Whether activities that produce gross income contribute importantly to the accomplishment of any purpose for which an organization is recognized as exempt, depends in each case upon the facts and circumstances involved. Following are illustrations of this principle.

## C.1. Schools

- (1) Treas. Reg. 1.513-1(d)(4)(i) gives several examples that illustrate the application of the "contribute importantly" principle. The following revenue rulings offer additional examples of how this rule is applied in educational contexts:
  - a. The regular sales of membership mailing lists by an exempt educational organization to universities and business firms is an activity that doesn't contribute importantly to the accomplishment of the organization's exempt purposes. See Rev. Rul. 72-431, 1972-2 C.B. 281. But see Section 513(h) and the discussion of member list exchanges and rentals in Part VII.I of this document.
  - b. A travel tour program operated by a university alumni association for members and their families, under which the association, working with various travel agencies, schedules several tours annually to destinations around the world, mails out promotional material, accepts reservations, and is paid a fee by the travel agencies on a per person basis, is an unrelated trade or business within the meaning of Section 513. See Rev. Rul. 78-43, 1978-1 C.B. 164. Also, Treas. Reg. 1.513-7 discusses the travel and tour activities of tax-exempt organizations.
  - c. An exempt school operates a ski facility for use in its physical education program and also for use, to a substantial degree, for recreational purposes by students attending the school and members of the public who are required to pay slope and ski lift fees comparable to nearby commercial facilities. The recreational use of the facility by students is substantially related and contributes importantly to the school's exempt purposes and the income derived from the students' use of the facility isn't from unrelated trade or business. However, income from use by the public is from unrelated trade or business. See Rev. Rul. 78-98, 1978-1 C.B. 167. See also Rev. Rul. 80-297, 1980-2 C.B. 196 which is discussed in Part VI.B.4(3) of this document.

- d. An organization's operation of vending machines and laundromat facilities on a university's campus is substantially related to the organization's exempt purposes where the organization operates as an integral part of the university, assisting the university and carrying out its activities. See Rev. Rul. 81-19, 1981-1 C.B. 353.
- e. A university enters into a joint venture with a for-profit company (LLC) to produce interactive video teacher training seminars. Although each partner holds a 50% interest, the university alone approves the curriculum, training materials and instructors, and determines the standards for successfully completing the seminars. All contracts and transactions entered into by the LLC are at arm's length and for fair market value. The LLC members' ownership interests and all returns of capital, allocations and distributions by the LLC are proportional to the members' respective capital contributions. A Section 501(c)(3) organization may form and participate in a partnership and meet the Section 501(c)(3) operational test if (1) participation in the partnership furthers an exempt purpose, and (2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. The revenue ruling holds that the activities conducted through the joint venture are substantially related to the university's educational purposes. See Rev. Rul. 2004-51, 2004-1 C.B. 974.

## C.2. Hospitals

- (1) The leasing of its adjacent office building and the furnishing of certain office services by an exempt hospital to a hospital-based medical group isn't unrelated trade or business. See Rev. Rul. 69-463, 1969-2 C.B. 131. See also Treas. Reg. 1.514(b)-1(c)(1) (treating as substantially related an exempt hospital's lease of clinic space to an association of physicians who provide out-patient medical and surgical services and train the hospital's residents and interns).
- (2) The operation by a Section 501(c)(3) hospital of a gift shop patronized by patients, visitors making purchases for patients, and employees doesn't constitute unrelated trade or business. See Rev. Rul. 69-267, 1969-1 C.B. 160.
- (3) Similarly, the operation by a Section 501(c)(3) hospital of a cafeteria and coffee shop primarily for its employees and medical staff doesn't constitute unrelated trade or business. See Rev. Rul. 69-268, 1969-1 C.B. 160.
- (4) Also, the operation by a Section 501(c)(3) hospital of a parking lot for patients and visitors only doesn't constitute unrelated trade or business. See Rev. Rul. 69-269, 1969-1 C.B. 160.
- (5) See Rev. Rul. 68-376, 1968-2 C.B. 246, for a discussion of situations in which persons who purchase pharmaceutical supplies from an exempt hospital are considered "patients" of the hospital for purposes of determining whether the

hospital is engaged in unrelated business under the Section 513(a)(2) exception for convenience of patients or otherwise.

- (6) The sale of hearing aids to its patients by an exempt hospital whose primary activity is rehabilitating the handicapped, including those with hearing deficiencies, doesn't constitute unrelated trade or business. See Rev. Rul. 78-435, 1978-2 C.B. 181.
- (7) Rev. Rul. 68-375, 1968-2 C.B. 245, holds that the sale of pharmaceutical supplies by an exempt hospital to private patients of physicians with offices in a hospital-owned medical building constitutes unrelated trade or business. The revenue ruling states that because these customers aren't patients of the hospital, such sales aren't primarily for the convenience of the hospital's patients and there is otherwise no substantial causal relationship between the pharmacy sales and the furthering of the hospital's exempt purpose.
- (8) In *Carle Foundation v. United States*, 611 F. 2d 1192 (7th Cir. 1979), cert. denied, 449 U.S. 824 (1980), a hospital pharmacy sold drugs to both hospital patients and the private patients of doctors who operated an independent clinic on a for-profit basis in offices located in the hospital complex. The appellate court reversed the lower court and found no evidence that pharmacy sales to the clinic and the clinic's private patients furthered the hospital's exempt purpose. Therefore, the court held that these sales gave rise to unrelated business taxable income.
  - a. Compare *Hi-Plains Hospital v. United States*, 670 F. 2d 528 (5th Cir. 1982), where the appellate court reversed the lower court and held that pharmacy sales to private patients of staff physicians were substantially related to a hospital's exempt purpose where such sales were used as an inducement to recruit doctors to work in a rural community.
- (9) In *St. Luke's Hospital of Kansas City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980), the court held that an exempt hospital's performance of diagnostic laboratory testing upon specimens of patients of the hospital's staff physicians wasn't unrelated trade or business under Section 513. The court found that the hospital needed the specimens to carry on its educational activities. As an independent basis for its holding, the court also stated that the hospital's staff physicians were "members" of the hospital within the meaning of Section 513(a)(2), and that testing was performed by the hospital primarily for the convenience of the hospital's members.
  - a. Rev. Rul. 85-109, 1985-2 C.B. 165, states that the IRS won't follow that portion of the *St. Luke's Hospital of Kansas City* holding that private patient specimen testing is for the convenience of the hospital's members and therefore not an unrelated trade or business. The IRS position is that hospital staff physicians are neither "members" nor "employees" of the hospital in their capacities as private practitioners of medicine. Therefore, by providing laboratory testing services on tissue specimens referred by its staff physicians in their private capacities, the hospital isn't carrying on

an activity primarily for the convenience of its members, officers, or employees per Section 513(a)(2).

- b. On the other hand, the revenue ruling also states that because the laboratory testing services provide a supply of specimens needed in the hospital's teaching program, they're substantially related to the hospital's exempt purpose.
- c. Rev. Rul. 85-110, 1985-2 C.B. 166, holds that the performance of diagnostic laboratory testing by an exempt non-teaching hospital upon specimens from private office patients of the hospital's staff physicians constitutes unrelated trade or business if such services are otherwise available in the community. The revenue ruling notes that unique circumstances may exist whereby such services may further the hospital's exempt purpose. Unique circumstances might include emergency laboratory diagnosis of blood samples from nonpatient drug overdose or poisoning victims, or laboratory testing where other laboratories aren't available within a reasonable distance from the area served by the hospital or are unable or inadequate to conduct tests needed by hospital nonpatients. The IRS will decide whether these unique circumstances exist on a case-by-case basis.

### **C.3. Broadcasting**

- (1) A state university operated two noncommercial radio stations and a commercially sponsored television station. The commercially operated television station was held not to be substantially related to the university's exempt educational purpose. It was also held that the university couldn't offset net losses derived from the noncommercial radio stations (which weren't unrelated business activities) against income derived from the commercial television station. See *Iowa State University of Science and Technology v. United States*, 500 F. 2d 508 (Ct. Cl. 1974).
- (2) An organization was formed for the purpose of advancing education and religion. In furtherance of this purpose, it broadcasts religious and educational programs for all but an insubstantial amount of its broadcast time from a television station it owns and operates under a commercial broadcasting license. The organization may qualify under Section 501(c)(3) even though its remaining broadcast time is devoted to other types of programs that are commercially sponsored; however, these programs constitute unrelated trade or business under Section 513. See Rev. Rul. 68-563, 1968-2 C.B. 212 and Rev. Rul. 78-385, 1978-2 C.B. 174.
- (3) The sale of broadcasting rights to sporting events sponsored by a Section 501(c)(6) organization whose purpose is to promote interest in a particular sport, to elevate the standards of the sport as a profession, and to sponsor and conduct tournaments for the encouragement of its members, is directly related to the purposes for which the organization was recognized exempt,

notwithstanding the amount of income received from the sale of broadcasting rights. See Rev. Rul. 80-294, 1980-2 C.B. 187.

- (4) The sale of radio and television broadcasting rights to an independent producer by a Section 501(c)(3) organization created as a national governing body for amateur athletics, whose purpose is to promote amateur athletics, is substantially related to the purpose constituting the basis for this organization's exemption, and is therefore, not unrelated trade or business within Section 513. See Rev. Rul. 80-295, 1980-2 C.B. 194.
- (5) Similarly, the sale of broadcast rights to an annual intercollegiate athletic event by a Section 501(c)(3) organization created by a regional collegiate athletic conference contributes importantly to the accomplishment of that organization's exempt purposes and is substantially related to the purpose constituting the basis for the organization's exemption and therefore not unrelated trade or business within the meaning of Section 513. The Service has traditionally taken the position that income from admissions to college and university athletic events isn't income from unrelated business because the events themselves are related to the educational purposes of the colleges and universities. See Rev. Rul. 80-296, 1980-2 C.B. 195.

#### **C.4. Museums**

- (1) The sale of greeting card reproductions of art works by an art museum described in Section 501(c)(3) doesn't constitute unrelated trade or business because the sale contributes importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art. See Rev. Rul. 73-104, 1973-1 C.B. 263.
- (2) The sale of scientific books and city souvenirs by a museum of folk art described in Section 501(c)(3) constitutes trade or business unrelated to the museum's exempt function but the sale of reproductions of art from the museum's own collection and reproductions of other art not owned by the museum are related because they contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art. See Rev. Rul. 73-105, 1973-1 C.B. 264.
- (3) The operation of a dining room, cafeteria, and snack bar by an exempt art museum for use by the museum staff, employees, and members of the public visiting the museum doesn't constitute an unrelated trade or business activity because they contribute importantly to the museum's exempt purposes by helping visitors devote a greater portion of their time to the museum's collection than would be the case if they had to seek outside eating facilities. See Rev. Rul. 74-399, 1974-2 C.B. 172.

## C.5. Retail Merchants

- (1) The operation of a coupon redemption service for the members of an association of retail food merchants, exempt under Section 501(c)(6), doesn't contribute importantly to the exempt purposes of the association, the promotion of a common business interest, and instead constitutes the performance of services for individual members for a fee; it therefore constitutes the conduct of unrelated trade or business within the meaning of Section 513. See Rev. Rul. 68-267, 1968-1 C.B. 284.
- (2) An exempt organization's operation of a retail grocery store as part of its therapeutic program for emotionally disturbed adolescents, almost fully staffed by the adolescents, and on a scale that is no larger than is reasonably necessary for the performance of the organization's exempt functions, isn't unrelated trade or business. See Rev. Rul. 76-94, 1976-1 C.B. 171.
- (3) The operation of a fringe parking lot and a shuttle bus service that favors no individual merchant or group of merchants, by a Section 501(c)(6) organization whose primary purpose is to retain and stimulate trade in a city's downtown area, isn't an unrelated trade or business. However, the organization's operation of a park and shop plan in which patrons of particular members receive stamps entitling them to free parking isn't substantially related because it constitutes the provision of a particular service to individual members rather than being directed to the improvement of business conditions of one or more lines of business; it is therefore unrelated trade or business per Section 513. See Rev. Rul. 79-31, 1979-1 C.B. 206.

## C.6. Credit Unions

- (1) While federal credit unions described in Section 501(c)(1) aren't subject to the UBIT (see Section 511(a)(2)(A)), state-chartered credit unions described in Section 501(c)(14)(A) are subject to the tax.
- (2) *Bellco Credit Union v. United States*, 735 F.Supp. 2d 1286 (D. Colo. 2010) held that the sale of credit life and credit disability insurance to members wasn't subject to UBIT because it was substantially related to the organization's exempt purposes of promoting member thrift and that income from the sale of accidental death and dismemberment insurance (AD&D) wasn't unrelated business income because it was royalty income. In determining that the income was royalties, the court considered whether the income related to payments for services or payments for intangibles and concluded that the minimal work the credit union did for the AD&D program related to protecting its goodwill and not to promoting the AD&D program.
- (3) *Community First Credit Union v. United States*, 2009 WL 2058476 (E.D. Wis. 2009) denied the government's challenge to a jury verdict that the sale of credit life and disability insurance to members wasn't subject to UBIT and that the sale of Guaranteed Asset Protection (GAP) insurance wasn't subject to UBIT.

- (4) After these cases, the IRS will treat income from credit life and credit disability insurance and GAP auto insurance as not subject to UBIT, and income from all other insurance products (including AD&D) as subject to UBIT unless there is a royalty arrangement. See TEGE-04-0314-0005.

## C.7. Other Examples

- (1) A Section 501(c)(5) agricultural organization, whose primary purpose is to promote the betterment of conditions of breeders of Angus cattle and to improve the breed generally engages in unrelated trade or business when it regularly sells cattle for its members on a commission basis because the sale itself neither promotes the betterment of conditions of the cattle breeders nor improves the breed generally but is carried on for the convenience of members and the production of income. See Rev. Rul. 69-51, 1969-1 C.B. 159.
- (2) A Section 501(c)(6) exempt association of credit unions that, as part of its activities, publishes and sells to its members a consumer-oriented magazine designed as a promotional device for distribution to their depositors is engaged in an unrelated trade or business. See Rev. Rul. 78-52, 1978-1 C.B. 166.
- (3) The rental of studio apartments to artist-tenants and the operation of a dining hall primarily to serve these tenants have no substantial causal relationship to the achievement of the exempt purposes of a Section 501(c)(3) fine arts organization created to stimulate and foster public interest in the fine arts by promoting of art exhibits, sponsoring of cultural events, conducting educational programs, and disseminating of information relative to fine arts. Although the studio apartments are leased only to artists, they aren't leased on the basis of any criteria that further the exempt purposes of the organization, and occupancy in the apartments isn't primarily for the convenience of the members within the meaning of Section 513(a)(2). The dining hall is operated primarily to serve the tenants of the studio apartments in their capacity as tenants and only incidentally to serve the organization's employees. Therefore, these activities are unrelated trades or businesses. See Rev. Rul. 69-69, 1969-1 C.B. 159.
- (4) An exempt Section 501(c)(6) business league that provides job injury histories on prospective employees from public state workman's compensation records to prospective employers on an expedited basis for a specified fee is engaged in an unrelated trade or business. See Rev. Rul. 73-386, 1973-2 C.B. 191.
- (5) The provision of pet boarding and grooming services for the general public is unrelated to the exempt purposes of a Section 501(c)(3) organization operated for the prevention of cruelty to animals. See Rev. Rul. 73-587, 1973-2 C.B. 192.
- (6) In Rev. Rul. 78-51, 1978-1 C.B. 165, the IRS concluded that the sale, at a profit, of standard legal forms by a local bar association described in Section 501(c)(6) may be an unrelated trade or business within the meaning of Section 513.
  - a. However, a court found that a local bar association's sale and distribution of a state bar's "standard" real estate forms and the forms manual was activity substantially related to the local bar association's exempt purpose



and wasn't an unrelated trade or business. See *San Antonio Bar Association v. United States*, 1980 WL 1624 (W.D. Tex. 1980).

- b. See also *Texas Apt. Ass'n v. U.S.*, 869 F.2d 884 (5th Cir. 1989) (finding that selling preprinted lease forms and a landlord's manual was activity substantially related to a Section 501(c)(6) trade association's exempt purpose and wasn't an unrelated trade or business).
- (7) The operation of a beauty shop and a barber shop for senior citizens is substantially related to the exempt purpose of a Section 501(c)(3) senior citizens center because it helps meet the psychological and health needs of the elderly in the area of personal grooming, an activity substantially related to the exempt purpose of the center. See Rev. Rul. 81-61, 1981-1 C.B. 355.
- (8) A language translation service provided by a Section 501(c)(6) organization that promotes and develops trade relations between business entities located in the U.S. and the government of a foreign country is unrelated trade or business within the meaning of Section 513. See Rev. Rul. 81-75, 1981-1 C.B. 356.
- (9) Assisting member cities in collecting unpaid taxes is substantially related to the exempt purpose of a Section 501(c)(4) civic league organization that was organized and operated to assist these cities. See *Kentucky Municipal League v. Commissioner*, 81 T.C. 156 (1983).
- (10) Administering vacation pay and guaranteed annual income accounts isn't substantially related to a Section 501(c)(6) organization's exempt purpose, which is to negotiate collective bargaining agreements and resolve disputes arising under such agreements. See *Steamship Trade Association of Baltimore, Inc. v. Commissioner*, 757 F. 2d. 1494 (4th Cir. 1985).
- (11) Section 501(c)(4) homeowner's association generated unrelated business taxable income from fees from operating parking lots and a beach club accessible only by members during summer days. The parking lots and club were located eight miles from the subdivision. Because they weren't open to the public (unlike most of the association's other facilities and services), the operation of the parking lots and club didn't contribute to the social welfare of the general public and therefore weren't substantially related to the organization's exempt purpose. See *Ocean Pines Association, Inc. v. Commissioner*, 672 F.3d 284 (4th Cir. 2012) affirming 135 T.C. 276 (2010).

#### **D. Disposition of Products of Exempt Functions**

- (1) Ordinarily, gross income from the sale of a product that results from the performance of exempt functions doesn't constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in upon completion of the exempt functions. See Treas. Reg. 1.513-1(d)(4)(ii). However, if a product resulting from an exempt function is used or exploited in further business endeavors beyond what is reasonably appropriate or necessary for disposition in the state it is in upon completion of



the exempt function, the gross income derived therefrom would be from conduct of unrelated trade or business. See Treas. Reg. 1.513-1(d)(4)(ii).

- (2) This rule is shown in the following examples from Treas. Reg. 1.513-1(d)(4)(ii) and revenue rulings.
- a. In the case of an organization described in Section 501(c)(3) and engaged in a program of rehabilitation of handicapped persons, income from sale of articles made by such persons as a part of their rehabilitation training wouldn't be gross income from conduct of unrelated trade or business. The income in this case would be from sale of products, the production of which contributed importantly to the accomplishment of purposes for which exemption is recognized with respect to the organization, namely, rehabilitation of the handicapped. See also Rev. Rul. 68-581, 1968-2 C.B. 250 (income from sale by Section 501(c)(3) vocational school of woven products made by its students isn't UBTI); Rev. Rul. 73-128, 1973-1 C.B. 222 (income from sale by Section 501(c)(3) organization of toys manufactured in its vocational training program for unskilled persons isn't UBTI); Rev. Rul. 75-472, 1975-2 C.B. 208 (income from sale by Section 501(c)(3) halfway house of furniture manufactured primarily by persons discharged from alcoholic treatment centers isn't UBTI); and Rev. Rul. 76-37, 1976-1 C.B. 148 (income from sale by Section 501(c)(3) organization of houses built primarily by students in its on-the-job training program isn't UBTI).
  - b. In the case of an experimental dairy herd maintained for scientific purposes by a research organization described in Section 501(c)(3), income from the sale of milk and cream produced in the ordinary course of project operation wouldn't be gross income from the conduct of unrelated trade or business.
  - c. If the above research organization were to use the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.
  - d. Rev. Rul. 66-323, 1966-2 C.B. 216, held that the practice of a tax-exempt blood bank of selling blood and blood components to commercial laboratories was a business unrelated to the purpose of the blood bank's exemption, the collection and distribution of blood for the benefit of the public and related research.
  - e. Rev. Rul. 78-145, 1978-1 C.B. 169 modified Rev. Rul. 66-323 and held that the sale of plasma to commercial laboratories by an exempt blood bank, engaged in collecting and maintaining blood products for use by hospitals, wasn't an unrelated trade or business where the blood bank sells either by-product plasma from which red blood cells have been

removed for use by hospitals or plasma salvaged from whole blood nearing the end of its shelf life. However, sale of plasma derived from donors through plasmapheresis or purchased from other blood banks is an unrelated trade or business.

## E. Dual Use of Assets

- (1) If an asset or facility necessary to the conduct of exempt functions is also used in a commercial endeavor, the fact that the asset or facility is used for exempt functions doesn't, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. See Treas. Reg. 1.513-1(d)(4)(iii). See the example below.
  - a. A museum exempt under Section 501(c)(3) has a theater auditorium which is specially designed and equipped for showing educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from this operation would be gross income from conduct of unrelated trade or business. See Treas. Reg. 1.513-1(d)(4)(iii)
- (2) Operation of a mailing service for other organizations is unrelated trade or business even though the mailing equipment is also used for exempt activities. The mere fact of the use of the equipment in exempt functions doesn't make the income from the commercial endeavor gross income from related trade or business. See Rev. Rul. 68-550, 1968-2 C.B. 249.
- (3) An exempt school annually contracts with an individual who conducts a 10-week summer tennis camp, with the school furnishing the tennis courts, housing, dining facility and the individual hiring the instructors, recruiting campers, and providing supervision. The amounts received by the school are from unrelated trade or business and are generated through the dual use of facilities and personnel. Therefore, an allocable portion of expenses attributable to such facilities and personnel may be deducted in computing unrelated business taxable income under Section 512. See Rev. Rul. 76-402, 1976-2 C.B. 177. Amplified by Rev. Rul. 80-297, 1980-2 C.B. 196.
- (4) An exempt school operates a ski facility for use in its physical education program and also for use, to a substantial degree, for recreational purposes by students attending the school and members of the public who are required to pay slope and ski lift fees comparable to those of nearby commercial facilities. The recreational use of the facility by students is substantially related to the school's exempt purposes and the income derived from the students' use of the facility isn't from unrelated trade or business under Section 513. However,

income from use of the facility by the public is from unrelated trade or business. See Rev. Rul. 78-98, 1978-1 C.B. 167.

- (5) An organization formed for the purpose of advancing education and religion through operation of a television station on which it broadcasts educational and religious programs qualifies for exemption under Section 501(c)(3). However, the insubstantial amount of commercial programming which it broadcasts constitutes unrelated trade or business under Section 513 because the presentation of commercial programs and the sale of advertising for airtime in connection therewith aren't substantially related to the purposes forming the basis for exemption of the organization. See Rev. Rul. 78-385, 1978-2 C.B. 174.

## **F. Exploitation of Exempt Functions for Commercial Purposes**

- (1) In some cases, exempt activities will create goodwill or other intangibles which are capable of being exploited in commercial endeavors. Unless these commercial endeavors themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is from the conduct of unrelated trade or business. Treas. Reg. 1.513-1(d)(4)(iv) contains examples that illustrate this principle.

### **F.1. Advertising**

- (1) In *United States v. American College of Physicians*, 475 U.S. 834 (1986), a Section 501(c)(3) organization published a journal called *Annals of Internal Medicine*. The journal contained scholarly articles relevant to the practice of internal medicine, advertisements of pharmaceuticals, medical supplies, products, equipment useful in the practice of internal medicine, and notices of positions desired or available in connection with the practice of internal medicine. Advertisements in the journal were "stacked" in two sections, at the front of and behind the editorial content of each 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 Supreme Court held that advertising contained in the organization's journal wasn't substantially related to its exempt educational purpose. Although the Court rejected the Government's "per se" argument that advertising published in a tax-exempt professional journal can never be substantially related, it did conclude that, in this case, such advertising didn't contribute importantly to the organization's exempt purpose. See the Advertising Lead Sheet (Exhibit X.F of this document).
- (2) In *Fraternal Order of Police Illinois State Troopers Lodge No. 41 v. Commissioner*, 87 T.C. 747 (1986), the court held that income from advertising appearing in the Section 501(c)(8) organization's magazine, *The Trooper*, was subject to tax on unrelated business income. The court rejected the organization's arguments, stating that "paid business listings" appearing in *The*

Trooper constituted advertising and therefore were a trade or business, and that the royalty exclusion modification under Section 512(b)(2) wasn't applicable.

- (3) In *Arkansas State Police Association, Inc. v. Commissioner*, 282 F. 3d 556 (8th Cir. 2002), aff'g T.C. Memo. 2001-38, the court held that money received by the Section 501(c)(5) state police association from the publisher, for publishing the association's magazine three times a year, was unrelated business taxable income and not royalty income.
- (4) In *Florida Trucking Association, Inc. v. Commissioner*, 87 T.C. 1039 (1986), a Section 501(c)(6) organization published a newsletter or magazine called *Florida Truck News*, that contained advertisements pertaining to the trucking industry. The publication contained advertisements for truck-related products, including tires, engines, and trailers. Advertisements were often repeated. No formal screening process was used, and the content of the advertisements in each issue wasn't coordinated with the editorial content of the publication. The Tax Court held that the advertisements weren't substantially related to the organization's exempt purpose and, therefore, income from such advertisements was subject to tax on unrelated business income. The court viewed the advertisements as representing straightforward marketing techniques with no systematic effort to relate the products to the publication's editorial content, and with no screening process.
- (5) The exploitation of exempt functions in the context of advertising is illustrated by some of the examples in *Treas. Reg. 1.513-1(d)(4)(iv)*.
  - a. 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, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials doesn't contribute importantly to the accomplishment of any 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.
  - b. X, an exempt organization for the advancement of public interest in classical music, owns a radio station and operates it in a manner which contributes importantly to the accomplishment of the purposes for which the organization is granted exemption. However, in the course of the operation of the station the organization derives gross income from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station. Neither the sale of such time nor the performance of such services contributes importantly to the accomplishment of any purpose for which the organization is granted exemption. Notwithstanding the fact that the production of the advertising income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business.

- c. 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.
- d. 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 was granted to the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, doesn't 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.
- e. 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 isn't 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 doesn't 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.

- (6) Several revenue rulings also provide examples of advertising activities exploiting exempt functions.
- a. Income derived by a Section 501(c)(5) exempt organization from the sale of advertising in its annual yearbook is unrelated business taxable income where an independent commercial firm under a contract covering a full calendar year conducts an intensive advertising campaign in the organization's name and is paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook. See Rev. Rul. 73-424, 1973-2 C.B. 190.
  - b. Income derived by an association of law enforcement officials described in Section 501(c)(6), from the sale of space in its journal either for conventional advertising or merely to identify the purchasing organization without a further message constitutes unrelated business income. However, income derived from the listing of 60 names to a page that merely identifies the purchaser without a further advertising message wouldn't constitute unrelated trade or business because the purchaser of a listing neither expects nor receives more than an inconsequential benefit. See Rev. Rul. 74-38, 1974-1 C.B. 144, as clarified by Rev. Rul. 76-93, 1976-1 C.B. 170.
  - c. In Rev. Rul. 79-370, 1979-2 C.B. 238, the IRS distinguished Rev. Rul. 74-38 and held that the sale by an organization exempt under Section 501(c)(6) of a membership directory that contributes importantly to the achievement of the organization's purpose and confers no private commercial benefit on any of the members, who are the directory's sole purchasers, doesn't constitute unrelated trade or business within the meaning of Section 513. The listings in the directory don't emphasize the relative importance or reputation of certain members over others, and members aren't permitted to purchase over-size or specially designed listings.

- d. The sale of advertising during a four-month period by the paid employees of a Section 501(c)(3) exempt organization, which raised funds for an exempt symphony orchestra and published a weekly concert program distributed free at the symphony performances over an eight-month period, is a business subject to the unrelated business income tax because such activities don't substantially differ from the comparable commercial activities of non-exempt organizations. See Rev. Rul. 75-200, 1975-1 C.B. 163.
- e. The publishing of ordinary commercial advertisements for products and services used by the legal profession in the journal of a Section 501(c)(6) bar association constitutes unrelated trade or business under Section 513 because it doesn't advance the exempt purposes of the association, even when published in a periodical which contains editorial material related to exempt purposes. However, the publishing of legal notices doesn't constitute unrelated trade or business because this practice promotes the common interests of the legal profession and, therefore, contributes importantly to the accomplishment of the association's exempt purposes. See Rev. Rul. 82-139, 1982-2 C.B. 108.

## F.2. Other Examples

- (1) Other examples regarding exploitation of exempt functions set forth below are from Treas. Reg. 1.513-1(d)(4)(iv) except where noted.
  - a. U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment doesn't contribute importantly to the accomplishment of any purpose for which U's exemption is recognized. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.
  - b. V, an exempt university, has a regular faculty and a regularly enrolled student body. During the school year, V sponsors the appearance of professional theater companies and symphony orchestras that present drama and musical performances for the students and faculty members. Members of the general public are also admitted. V advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. V derives gross income from the conduct of the performances. However, while the presentation of the performances makes use of an intangible generated by V's exempt educational functions—the presence of the student body and faculty—the presentation of such drama and music events contributes importantly to the overall educational and cultural function of the university. Therefore, the income that V receives doesn't constitute gross income from the conduct of unrelated trade or business.

- c. An exempt school annually contracts with an individual who conducts a 10-week summer tennis camp with the school furnishing the tennis courts, housing, dining facility and the individual hiring the instructors, recruiting campers, and providing supervision. The tennis camp's patrons are attracted to the school primarily for its capacity to provide suitable tennis facilities and personnel. Its reputation as an educational institution is of secondary importance, if a factor at all, in attracting the patrons. So, the school isn't exploiting goodwill or other intangibles generated from the performance of its exempt function. The school is, however, using its educational facilities and personnel both for the accomplishment of its exempt purposes and for income-producing purposes that are unrelated to its exempt purposes. See Rev. Rul. 76-402, 1976-2 C.B. 177.

### **III. Unrelated Business Taxable Income**

- (1) This section provides information on the computation of unrelated business taxable income under Section 512.

#### **A. Overview**

- (1) As discussed previously in this guide, Section 511 imposes a tax on the UBTI of an exempt organization.
- (2) Once it is determined that an exempt organization is conducting a "trade or business" it is necessary to determine to what extent the income from such trade or business is subject to tax under Section 511. In general, the computation of UBTI is affected by a series of modifications found in Section 512(b) and certain items that are excluded per Section 513. These modifications and exclusions are discussed in Parts III-VII of this document.

#### **B. Deductions and Expenses**

- (1) Per Section 512(a) and Treas. Reg. 1.512(a)-1, when computing its unrelated business taxable income, the organization may deduct expenses, depreciation and similar items as allowed by Chapter 1 of the Code if such items are directly connected with the carrying on of an unrelated trade or business.
- (2) Except as discussed below, to be "directly connected with" the conduct of unrelated trade or business for purposes of Section 512, an item of deduction must have a proximate and primary relationship to the carrying on of unrelated trade or business. See Treas. Reg. 1.512(a)-1(a).
- (3) In the case of an organization with more than one unrelated trade or business, unrelated business taxable income is calculated separately with respect to each such trade or business, as discussed in Part III.G of this document. See Treas. Reg. 1.512(a)-6.



## **B.1. Expenses Attributable Solely to Unrelated Business Activities**

- (1) Expenses, depreciation, and similar items attributable solely to the conduct of unrelated trade or business are proximately and primarily related to that business activity. Therefore, such expenses are deductible to the extent that they meet the requirements of Section 162, Section 167, or other relevant provisions of the Code in computing the unrelated business taxable income of the organization. See Treas. Reg. 1.512(a)-1(b).

## **B.2. Expenses Attributable Solely to Organization's Exempt Purpose**

- (1) Expenses attributable solely to accomplishing an organization's exempt purpose may not be deducted from the organization's unrelated business income because such expenses don't possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity. See, for example, *Iowa State University of Science & Technology v. United States*, 500 F.2d 508 (1974), where the court held that the expenses of an exempt radio station couldn't be deducted against the income from a nonexempt television station even though the stations shared facilities and staff.

## **B.3. Allocation for Dual Use of Facilities or Personnel**

- (1) Where facilities or personnel are used both for exempt functions and the conduct of unrelated trade or business, the expenses, depreciation, and similar items attributable to such facilities or personnel must be allocated between the two uses on a reasonable basis.
- (2) However, allocation of expenses, depreciation, and similar items isn't reasonable if the cost of providing a good or service in a related and an unrelated activity is substantially the same, but the price charged for that good or service in the unrelated activity is greater than the price charged in the related activity and no adjustment is made to equalize the price difference for purposes of allocating expenses, depreciation, and similar items based on revenue between related and unrelated activities. For example, if a social club described in Section 501(c)(7) charges nonmembers a higher price than it charges members for the same good or service but doesn't adjust the price of the good or service provided to members for purposes of allocating expenses, depreciation, and similar items attributable to the provision of that good or service, the allocation method isn't reasonable. See Treas. Reg. 1.512(a)-1(c).
- (3) The portion of such items allocated to the unrelated business activity is considered proximately and primarily related to that business activity and is allowable as a deduction in computing the unrelated business taxable income to the extent permitted by Section 162, Section 167, or other relevant provisions of the Code. The following examples discuss this principle.
  - a. X, an exempt organization subject to the provisions of Section 511, pays its president a salary of \$20,000 a year. X derives gross income from the

conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his/her time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of \$2,000 (10 percent of \$20,000) is allowed for the salary paid to its president. See Treas. Reg. 1.512(a)-1(c).

b. Amounts received by an exempt school that annually contracts with an individual who conducts a summer tennis camp with the school furnishing the tennis courts, housing and dining facilities are from dual use of facilities and personnel. An allocable portion of expenses attributable to the facilities and personnel may be deducted in computing unrelated business taxable income. Rev. Rul. 76-402, 1976-2 C.B. 177, amplified by Rev. Rul. 80-297, 1980-2 C.B. 196.

- (4) In *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), a Section 501(c)(3) educational organization operated a field house, which it devoted to two uses: student use, including physical education, college ice hockey and student ice skating, and commercial use, including commercial ice shows and public ice skating. Amounts derived from commercial use constitute unrelated business taxable income, and at issue was the correct allocation of indirect expenses. The organization contended that it was entitled to allocate fixed expenses on the basis of actual use, while the IRS argued that such allocation should be based on the total time available for use. The court agreed with the organization and held that apportioning indirect expenses such as depreciation on the basis of actual hours used is a reasonable method of allocation under Treas. Reg. 1.512(a)-1(c). In light of the amendments to Treas. Reg. 1.512(a)-1(c) effective for tax years beginning on or after December 2, 2020, accordingly, the IRS rescinds the AOD to the limited extent of any allocation method that fails to equalize price differences between related activities and unrelated trade or business activities for such taxable years. See TD 9933, 85 FR 77952-01, 77957. See Income and Expense Allocation/Tax Computation Lead Sheet (Exhibit X.E of this document) for additional information.
- (5) In *CORE Special Purpose Fund v. Commissioner*, T.C. Memo. 1985-48, the court denied an exempt organization business expense deduction in computing unrelated business taxable income attributable to the sale of advertising in an organization's magazines. Although the organization received income from advertising, the advertising regulations under Treas. Reg. 1.512(a)-1(f) couldn't be applied because the issue of whether the fund's publication of the readership content of the magazines is an exempt activity hasn't been decided, stipulated to, or presented for decision and because the Commissioner couldn't apply them, due to the fund's failure to produce credible evidence of its advertising and publishing expenses. The general allocation requirements under Treas. Reg. 1.512(a)-1(c) were deemed applicable. The court held that deductions weren't allowed because the organization didn't adequately substantiate a claim that such expenses were incurred or were directly connected with the unrelated

advertising activity. The court allowed the organization to deduct a portion of its claimed legal and accounting fees and telephone expenses.

- (6) The Treasury Department and the IRS currently have an item on the Priority Guidance Plan under Treas. Reg. 1.512(a)-1(c) regarding methods of allocating expenses relating to dual use facilities. The allocation issues under Section 512(a)(1) remain relevant under Section 512(a)(6) because an exempt organization with more than one unrelated trade or business must not only allocate indirect expenses among exempt and taxable activities as described in Treas. Reg. 1.512(a)-1(c) and (d) but also among separate unrelated trades or businesses. The Treasury Department and the IRS therefore modified the underlying reasonable allocation method in Treas. Reg. 1.512(a)-1(c) and provided specific standards for allocating expenses relating to dual use facilities and the rules under Section 512(a)(6). The amendments to Treas. Reg. 1.512(a)-1(c) effective for tax years beginning on or after December 2, 2020, provides that “unadjusted gross to gross” isn’t a reasonable allocation method. Therefore, if the cost of providing a good or service in a related and an unrelated activity is substantially the same, but the price charged for that good or service in the unrelated activity is greater than the price charged in the related activity and no adjustment is made to equalize the price difference for purposes of allocating expenses, depreciation, and similar items based on revenue between related and unrelated activities, then the allocation of expenses isn’t reasonable. The AOD relating to *Rensselaer Polytechnic Institute v. Commissioner* stated that the IRS wouldn’t litigate the reasonableness of an allocation method “until the allocation rules of [Section 1.512(a)-1(c)] are amended.” See 732 F.2d 1058 (2d Cir. 1984), aff’g 79 T.C. 967 (1982); IRS AOD-1987-014 (June 18, 1987). The final regulations issued with TD 9333 amend the rules of Treas. Reg. 1.512(a)-1(c), and TD 9333 states: “the IRS rescinds the AOD to the limited extent of any allocation method that fails to equalize price differences between related activities and unrelated trade or business activities for such taxable years. The IRS will continue to refrain from litigating the reasonableness of other allocation methods pending the publication of further guidance, which the Treasury Department and the IRS continue to consider and expect to publish in a separate notice of proposed rulemaking.”

### **C. Exploitation of Exempt Functions**

- (1) In certain cases, gross income is derived from an unrelated trade or business activity which exploits an exempt activity. See Part II.F of this document. One example of such exploitation is the sale of advertising in a periodical of an exempt organization which contains editorial material related to the accomplishment of the organization’s exempt purpose. See Treas. Reg. 1.512(a)-1(f), which provides rules for determining the amount of unrelated business taxable income attributable to the sale of such advertising.

- (2) Generally, expenses, depreciation, and similar items attributable to the conduct of the exempt activities aren't deductible in computing unrelated business taxable income from exploitation of exempt functions. Such items are incident to an activity which is carried on in furtherance of the exempt purpose of the organization. They don't possess the necessary proximate and primary relationship to the unrelated trade or business activity and are, therefore, not directly connected with that business activity. See Treas. Reg. 1.512(a)-1(d).
- (3) In certain circumstances, however, expenses that are attributable to the exempt activity are also directly connected with carrying on the unrelated trade or business activity. See Treas. Reg. 1.512(a)-1(d)(2). For such expenses to be deductible, the unrelated business must be of a kind carried on for profit by taxable organizations and the exploited activity must be of a type normally conducted by taxable organizations in pursuance of such business. Even then, these expenses are allocated first to the exempt function to the extent of income derived from or attributable to it and only the balance, if any, is deductible against unrelated income. Furthermore, allocation of these expenses, that are ordinarily attributable to the exempt function, can be made to the unrelated business activity only to the extent that it doesn't result in a loss. See Treas. Reg. 1.512(a)-1(e) for more specific examples illustrating this section.

#### **D. Advertising – Unrelated Business Taxable Income**

- (1) The regulations set forth detailed rules for the determination of UBTI from the sale of advertising in exempt organization periodicals. See Treas. Reg. 1.512(a)-1(f). For such purpose, 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. See the Advertising Lead Sheet (Exhibit X.F of this document).
- (2) Gross advertising income is defined in Treas. Reg. 1.512(a)-1(f)(3)(ii) as all amounts derived from the unrelated advertising activities of an exempt organization periodical.
- (3) 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. See Treas. Reg. 1.512(a)-1(f)(3)(iii).
- (4) 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. See Treas. Reg. 1.512(a)-1(f)(6)(i).

- (5) Direct advertising costs include all expenses, depreciation and similar items of deduction which are directly connected with the sale, publication, and distribution of advertising. See Treas. Reg. 1.512(a)-1(f)(6)(ii)(a). See paragraph (7) below regarding allocation of mechanical and distribution costs.
- (6) 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 deductions that are attributable to an exempt organization's periodical that aren't allocated to direct advertising costs are included under readership costs. See Treas. Reg. 1.512(a)-1(f)(6)(iii). *National Association of Life Underwriters v. Commissioner*, 30 F.3d 1526 (D.C. Cir. 1994) held that using the ratio of journal to non-journal direct costs to allocate indirect costs was a reasonable method of allocation, but the prior year's numerical ratio wasn't a method of accounting that had to be used consistently year to year.
- (7) The mechanical and distribution costs (for example, costs of composition, presswork, binding, and mailing for hard-copy periodicals) 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. See Treas. Reg. 1.512(a)-1(f)(6)(ii)(c).
- (8) In *American Medical Association v. United States*, 887 F.2d 760 (7th Cir. 1989) the Seventh Circuit Court of Appeals followed a "dominant motivation" test in determining whether a cost was "directly connected with" an unrelated business. The American Medical Association (AMA) distributed a substantial number of copies of its periodicals free of charge. This "controlled circulation" was specifically directed at physicians who constitute an especially attractive audience for persons likely to advertise in the journals. The parties stipulated that the sole purpose behind the AMA's controlled circulation was to appeal to advertisers. The IRS argued that the regulations adopt a purely objective standard for determining the nature of an expense, if the expense is related to the production or distribution of the journal's articles, it is a "readership cost" deductible from advertising income only if circulation income is negative; if the expense is proximately related to production or distribution of advertising, it is a "direct advertising cost" and fully deductible from advertising revenue. The appeals court found this reading to be an overly restrictive construction of the regulations. In finding that the costs of producing articles in copies of the AMA's journals distributed free of charge as part of the AMA's controlled circulation were fully deductible "direct advertising costs," the court concluded that where the clearly dominant motivation of a given expenditure is to contribute to the taxable, unrelated enterprise, that cost is "directly connected with" the taxable enterprise and, therefore, deductible in its entirety from the income of the unrelated trade or business.

## **D.1. Income and Deductions Attributable to Exempt Organization Periodicals**

- (1) If the direct advertising costs exceed the gross advertising income (and assuming the advertising activity qualifies as an unrelated trade or business), the excess is allowable as a deduction in determining UBTI. Under the Section 512(a)(6) silo rules, however, the deduction may be applied to offset UBI from the trade or business containing advertising only.
- (2) If the gross advertising income of the periodical exceeds the direct advertising costs, then 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. See Treas. Reg. 1.512(a)-1(d)(2) and 1.512(a)-1(f)(2)(ii).
- (3) 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. See Treas. Reg. 1.512(a)-1(d)(2) and 1.512(a)-1(f)(2)(ii).

## **D.2. 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. Treas. Reg. 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) doesn't apply and 20 percent or more of the organization's members pay lower dues than other members because the former doesn't 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, Treas. Reg. 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 of an organization's exempt activities including the periodical. 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) The regulations were challenged in *American Medical Association v. United States*, cited above in D.(8), on procedural and substantive grounds. On appeal, the regulations were upheld by the Seventh Circuit. In the various opinions on *American Medical Association*, the courts set forth the following regarding membership dues allocations:
  - a. Dues placed in an association equity fund must be included in membership receipts for purposes of the pro rata allocation formula under Treas. Reg. 1.512(a)-1(f)(4)(iii),
  - b. Dues collected from members who would have received periodicals free of charge even if they hadn't been dues-paying members should be included in calculating membership receipts allocable to circulation income under Treas. Reg. 1.512(a)-1(f)(4)(iii),
  - c. The cost of other exempt activities under Treas. Reg. 1.512(a)-1(f)(4)(iii) includes all costs of other periodicals, not just readership costs,
  - d. The one-year subscription rate (rather than one-half the two-year subscription rate) should be used in calculating membership receipts allocable to circulation income under Treas. Reg. 1.512(a)-1(f)(4)(iii), and
  - e. A portion of reduced dues paid by medical students, interns and residents may be used in calculating membership receipts under Treas. Reg. 1.512(a)-1(f)(4)(i).
- (3) In *American Hospital Association v. United States*, 654 F. Supp. 1152 (N.D. Ill. 1987) the court held that free distribution of a Section 501(c)(6) organization's periodicals to nonmembers shouldn't be included in determining whether 20 percent or more of total circulation consisted of sales to nonmembers under Treas. Reg. 1.512(a)-1(f)(4)(i).
- (4) *North Carolina Citizens for Business and Industry v. United States*, 18 Cl. Ct. 106 (1989), held that total circulation included distribution to persons designated by members where members received a subscription for every \$50 paid in dues and could designate recipients, and the organization treated such distribution as paid circulation for postal purposes.
- (5) In *American Bar Association v. United States*, 53 AFTR 2d 84-851 (N.D. Ill. 1984), the court permitted a Section 501(c)(6) organization to take into account the costs of a separate fund described in Section 501(c)(3) for purposes of calculating the pro rata allocation of membership receipts formula under Treas. Reg. 1.512(a)-1(f)(4)(iii). Although the fund was a separate fund like that



described in Rev. Rul. 54-243, 1954-1 C.B. 92, which maintained separate financial records and had a separate tax exemption, the fund had no separate legal existence.

- (6) A detailed example of the allocation of membership receipts to advertising income under the formula given in Treas. Reg. 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 aren't offset by any income earned by the organization from such activities. See examples in Treas. Reg. 1.512(a)-1(f)(2)(iii).

### **D.3. Consolidation of Periodicals' Income and Deductions**

- (1) Where an exempt organization publishes two or more periodicals for the production of income, it may consolidate the gross income for all periodicals and the items of deduction directly connected with the periodicals (including the readership costs) for purposes of computing the unrelated business taxable income derived from the sale of advertising in the periodicals. Consolidation may not be applied to less than all periodicals of the organization and, once adopted, this treatment is binding unless consent is obtained as provided in Section 446(e) and Treas. Reg. 1.446-1(e). See Treas. Reg. 1.512(a)-1(f)(7). See the Advertising Lead Sheet (Exhibit X.F of this document).
- (2) Under Treas. Reg. 1.512(a)-1(f)(7)(ii), a periodical is considered "published for the production of income" if:
  - a. The gross advertising income received from the periodical generally is equal to at least 25 percent of the readership costs, and
  - b. The publication of the periodical is an activity engaged in for profit.
- (3) Treas. Reg. 1.512(a)-1(f)(7) provides, in pertinent part, that the determination of whether the publication of a periodical is an activity engaged in for profit is to be made by reference to objective standards taking into account all the facts and circumstances involved in each case. The facts and circumstances must indicate that the organization carries on the activity with the objective that the publication of the periodical will result in economic profit (without regard to tax consequences), although not necessarily in a particular year. Thus, an exempt organization periodical may be treated as having been published with such an objective even though in a particular year its total periodical costs exceed its total income. Similarly, if an exempt organization begins publishing a new periodical, the fact that the total periodical costs exceed the total income for the start-up years because of a lack of advertising sales doesn't mean that the periodical was published without an objective of economic profit. The organization may establish that the activity was carried on with such an objective. This might be established by showing, for example, that there is a reasonable expectation that the total income, by reason of an increase in



advertising sales, will exceed costs within a reasonable time. See Treas. Reg. 1.183-2 for additional factors bearing on this determination.

- (4) Thus, readership losses from one periodical can be used to offset advertising income from another periodical only if both are published for the production of income, as defined above. If publication of a periodical isn't an activity engaged in for profit, then it isn't a trade or business and the income and expenses relating to such publication aren't taken into account in determining the organization's UBTI. See, for example, *West Virginia State Medical Association v. Commissioner*, 91 T.C. 651 (1988), *aff'd*, 882 F.2d 123 (4<sup>th</sup> Cir. 1989).

## **E. Special Rules for Foreign Organizations**

- (1) Per Section 512(a)(2) and Treas. Reg. 1.512(a)-1(g), a foreign organization which is described in Section 511 will be taxed on:
  - a. Unrelated business taxable income, which is derived from sources within the United States, but which isn't effectively connected with the conduct of a trade or business within the United States, plus,
  - b. Unrelated business taxable income effectively connected with the conduct of a trade or business within the United States whether or not such income is derived from sources within the United States.
- (2) For guidance on how to determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see part I, subchapter N, chapter 1 of the Code (Section 861 and following) and the regulations thereunder. See Treas. Reg. 1.512(a)-1(g). See also Part II.A.2 of TG 64 (Foreign Organizations) for a discussion of whether certain investment income is derived from sources within the United States.

## **F. Special Rules for Veterans Organizations**

- (1) Section 512(a)(4) and Treas. Reg. 1.512(a)-4(b) excludes from unrelated business taxable income amounts attributable to payments for life, sick, accident or health insurance with respect to the members of Section 501(c)(19) veterans' organizations or their dependents, provided such amounts are set aside for the payments of insurance benefits, the administrative costs of administering the insurance program or for purposes described in Section 170(c)(4) (religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals).
- (2) If the income from such an insurance set-aside is used for any other purpose, such amount is included in unrelated business taxable income without regard to any modifications provided in Section 512(b), in the taxable year in which it is withdrawn from the set-aside. See Treas. Reg. 1.512(a)-4(a).
- (3) To properly set aside the income from the insurance fund, an organization must keep adequate records describing the amount set aside and indicating the

purpose for which it is to be used. The funds may not be commingled with other funds not to be set aside. Treas. Reg. 1.512(a)-4(b)(5). Income which has been set aside may be invested, pending the action contemplated by the set-aside, without being regarded as having been used for other purposes. Treas. Reg. 1.512(a)-4(b)(5).

## **G. Separate Trade or Business (Siloing)**

- (1) The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 (TCJA) amended Section 512(a) by adding Section 512(a)(6) which requires an exempt organization with more than one unrelated trade or business to compute its unrelated business taxable income separately after December 31, 2017, with respect to each unrelated trade or business. It must also determine any net operating losses (NOL) separately with respect to each unrelated trade or business. NOL carryforwards must also be maintained separately. This is sometimes referred to as “siloing,” because each trade or business is separated into its own silo before the total amount of unrelated business taxable income is determined.
- (2) Treas. Reg. 1.512(a)-6 provides guidance on how an exempt organization subject to the unrelated business income tax determines if it has more than one unrelated trade or business, and, if so, how the exempt organization calculates unrelated business taxable income. The final regulations, whose effective date is for tax years beginning on or after December 2, 2020, also added a new paragraph to Treas. Reg. 1.513-1 to clarify that the definition of “unrelated trade or business” in Section 513(b) applies to individual retirement accounts and revised Treas. Reg. 1.512(b)-1(a) to clarify that inclusions of subpart F income and global intangible low-taxed income (or “GILTI”) are treated in the same manner as dividends for purposes of Section 512.
- (3) Under Section 512(a)(6), the unrelated business taxable income of each separate trade or business is calculated without regard to the \$1,000 specific deduction provided by Section 512(b)(12). The \$1,000 specific deduction is only applied after the UBTI of each separate trade or business is added to produce an exempt organization’s total UBTI. The \$1,000 specific deduction is then taken against this total UBTI value. Each exempt organization is allowed only one specific deduction of \$1,000 regardless of how many separate unrelated trades or businesses it operates. And for purposes of calculating total unrelated business taxable income, the unrelated business taxable income with respect to any trade or business can’t be less than zero.

### **G.1. North American Industry Classification System (NAICS) Activity**

- (1) Generally, Treas. Reg. 1.512(a)-6 provides that a separate unrelated trade or business is identified by the first two digits of the North American Industry Classification System code (NAICS 2-digit code) that most accurately describes the exempt organization's trade or business activity. In addition, the final regulations add that this determination is based on the more specific NAICS

code, such as at the 6-digit level, that describes the activity that it conducts. The final regulations also state that the descriptions in the current NAICS manual of trades or businesses (available at [www.census.gov](http://www.census.gov)) using more than two digits of the NAICS codes are relevant in this determination. Essentially, if two or more unrelated activities have the same first two digits under the NAICS codes, then those activities will be placed in the same “silo” and thus reported on the same Form 990-T, Schedule A. Note: The NAICS updates its business activity codes every 5 years. See [www.census.gov](http://www.census.gov).

## G.2. Investment Activities

- (1) Generally, investment activities aren’t identified using NAICS 2-digit codes. The NAICS codes are used to identify separate unrelated trades or businesses except to the extent provided in other paragraphs of the regulations. These codes are identified in the instructions to the Form 990-T.
- (2) Treas. Reg. 1.512(a)-6(c)(1) allows an exempt organization to treat its investment activities collectively as a single separate unrelated trade or business for purposes of Section 512(a)(6). This treatment recognizes the availability of different types of investments, and that exempt organizations often intend to limit their interest in an investment rather than investing with the intent to actively participate in a business generating UBI. Qualifying investment activities can be treated as a single unrelated trade or business.
- (3) Treas. Reg. 1.512(a)-6(c)(1) provides an exclusive list of investment activities that can be treated collectively as one separate unrelated trade or business for purposes of Section 512(a)(6). Generally, such investment activities are limited to:
  - a. Qualifying partnership interests (discussed in Part III.J.1 of this document),
  - b. Qualifying S corporation interests, and
  - c. Debt-financed properties.
- (4) The qualifying partnership interest rules don’t apply to social clubs described in Section 501(c)(7) according to Treas. Reg. 1.512(a)-6(c)(8). However, for organizations subject to Section 512(a)(3), which includes social clubs, (as well as Section 501(c)(9) VEBA’s and Section 501(c)(17) SUB trusts), Treas. Reg. 1.512(a)-6(c)(7) clarifies that unrelated business income from the investment activities of organizations includes certain additional amounts. Generally, UBTI from investment activities of an organization subject to Section 512(a)(3) includes amounts that would be excluded under Sections 512(b)(1), 512(b)(2), 512(b)(3) or 512(b)(5) if the organization were subject to Section 512(a)(1). See Treas. Reg. 1.512(a)-6(c)(7). See Part IV of this document for a discussion of UBTI under Section 512(a)(3).
- (5) A general partnership interest isn’t a qualifying partnership interest and thus can’t be aggregated with qualifying partnership interests or other investments as a single trade or business. See Treas. Reg. 1.512(a)-(6)(c)(8)(ii).

- (6) Generally, each of the following are treated as a separately reported unrelated trade or business:
- a. Directly held non-qualifying partnership interests acquired prior to August 21, 2018 (Treas. Reg. 1.512(a)-6(c)(9)),
  - b. Certain income from a Section 512(b)(13) controlled entity (Treas. Reg. 1.512(a)-6(d)(1)),
  - c. Certain amounts from a Section 512(b)(17) controlled foreign corporation (Treas. Reg. 1.512(a)-6(d)(2)), and
  - d. Certain amounts non-qualifying interests in an S corporation (Treas. Reg. 1.512(a)-6(e)(1)).

## H. Net Operating Loss

- (1) Per Section 512(b)(6), organizations subject to UBIT are permitted a net operating loss deduction provided under Section 172. Prior to December 31, 2017, NOLs generally could be carried back two years and carried forward twenty years. Beginning on January 1, 2018, NOLs are carried forward indefinitely and carrybacks were eliminated. Furthermore, the NOL was capped at 80% of UBTI. Notwithstanding, the 2020 Coronavirus Aid, Relief, and Economic Security Act (CARES Act) temporarily provided special NOL rules for taxable years beginning after December 31, 2017, and before January 1, 2021. During the CARES Act period, the 80% limitation was suspended, and a 5-year carryback was available. See Rev. Proc. 2020-24, 2020-18 I.R.B. 750.
- (2) For tax years beginning after December 31, 2017, Section 512(a)(6) changes how an exempt organization with more than one unrelated trade or business calculates and takes NOLs into account with respect to a particular trade or business, as discussed in Treas. Reg. 1.512(a)-6. In particular, Section 512(a)(6)(A) requires such an organization to calculate UBTI, including for purposes of determining any NOL deduction, separately with respect to each trade or business (siloeing) for taxable years beginning after December 31, 2017 (post-2017 NOLs).
- (3) In general, Section 512(a)(6) permits the carryover of any NOL arising in a taxable year beginning before January 1, 2018 (pre-2018 NOLs). In particular, section 13702(b)(2) of the TCJA provides that Section 512(a)(6)(A) doesn't apply to pre-2018 NOLs; rather, pre-2018 NOLs are taken against total UBTI calculated under Section 512(a)(6)(B). Accordingly, even though an exempt organization with more than one unrelated trade or business won't have any NOL deductions when calculating UBTI with respect to a separate trade or business under Section 512(a)(6)(A) for the first taxable year beginning after December 31, 2017, such an organization may be able to take an NOL deduction against total UBTI calculated for such year under Section 512(a)(6)(B) if the organization has pre-2018 NOLs.

- (4) Section 13702(b)(2) of the TCJA provides that Section 512(a)(6)(A) siloing doesn't apply to NOLs attributable to tax years ending on or before December 31, 2017. This differs from the treatment of post-2017 NOLs discussed earlier. *In sum, post-2017 NOLs are subject to the siloing rules. Pre-2018 NOLs aren't subject to the siloing rules.* Generally, an exempt organization that has both pre-2018 and post-2017 NOLs will first deduct its remaining pre-2018 NOLs from its total UBTI. It will then deduct any post-2017 NOLs for a given separate unrelated trade or business from the "siloed" UBTI for that same unrelated trade or business.
- (5) Under Treas. Reg. Section 1.512(a)-6(h)(2), pre-2018 NOLs continue being taken against total UBTI because siloing rules don't apply to these NOLs. However, the final regulations provide that organizations allocate their pre-2018 NOLs in a manner that allows maximum utilization of their post-2017 NOLs in that same tax year. For example, an organization may allocate all its pre-2018 NOLs to one of its separate unrelated trades or businesses, or it may allocate its pre-2018 NOLs ratably among its separate unrelated trades or businesses depending on which approach results in the greatest utilization of the post-2017 NOLs in that taxable year.

## **H.1. Summary of Modifications of Net Operating Loss Deduction for post-2017 tax years**

- (1) The TCJA enacted general changes to the NOL deduction under Section 172 for tax years beginning after December 31, 2017. In particular:
  - a. The post-2017 NOL deduction in any year is capped at 80% of UBTI.
  - b. The post-2017 NOL carryback (which previously applied to two taxable years) is eliminated.
  - c. The post-2017 NOL carryforward (which previously applied to 20 taxable years) is now indefinite.
  - d. Section 512(a)(6)(A) requires an exempt organization to calculate UBTI, including for purposes of determining any NOL deduction, separately with respect to each trade or business (siloing) for taxable years beginning after December 31, 2017 (post-2017 NOLs).
- (2) The CARES Act temporarily modified or suspended certain amendments to Section 172. On March 27, 2020, Congress amended Section 172 (Net Operating Loss Deduction) with the (CARES Act). The CARES Act provides that any net operating loss arising in a taxable year beginning after December 31, 2017, and before January 1, 2021 (CARES Act NOLs), may be carried back to the five taxable years preceding the taxable year of such loss, which includes taxable years prior to the enactment of Section 512(a)(6). If applied in a pre-2018 year, the NOL may be carried back to that non-silo year against aggregate UBTI. If applied in a post-2017 year, the NOL may be carried back to that silo year against the corresponding separate UBTI silo. The CARES Act also

suspended the 80% limitation (also known as the excess business loss limitation) for tax years beginning before January 1, 2021, The 80% limitation was enacted under the TCJA. As a reminder, this limited the allowable NOL deduction to 80% of taxable income, calculated as described in Section 172(a)(2) net operating loss deduction. Additionally, an organization may waive the CARES Act NOL carryback by attaching a statement to Form 990-T as described in Revenue Procedure 2020-24. The Priority Guidance Plan states that regulations under Section 512 would address how changes made to Section 172 net operating losses by section 2303(b) of the CARES Act apply for purposes of Section 512(a)(6).

## **I. Deduction for Recreational Expenses**

- (1) A deduction for expenses paid or incurred for recreational, social, or similar activities (including facilities therefor) isn't disallowed under Section 274 if the athletic facility is primarily for the benefit of the tax-exempt organization's employees and doesn't discriminate in favor of highly compensated employees. See Section 274(e)(4).

## **J. Special Rules for Partnerships**

- (1) Generally, the unrelated business taxable income provisions cover situations where an exempt organization itself pursued the unrelated trade or business as a part of its overall activities. If an exempt organization is a member of a partnership, however, it must treat its share of the partnership income in the same fashion as if it had conducted the business activity in its own capacity as a corporation or trust. See Section 512(c).
- (2) Section 512(c) provides that if an organization to which Section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the exempt entity must include in its unrelated business taxable income that portion of its share of the partnership gross income (whether or not distributed), and the deductions attributable thereto, which is derived from the unrelated trade or business.
- (3) The exceptions, additions and limitations contained in Section 512(b) also apply to partnership income and will, therefore, be taken into account for purposes of this computation. For instance, if an exempt educational institution is a partner in a partnership which operates a factory, and if such partnership also holds stock in a corporation, the exempt organization must include its share of the gross income from the operation of the factory in its unrelated business taxable income but may exclude its share of any dividends received by the partnership from the corporation. See Treas. Reg. 1.512(c)-1.
- (4) If the exempt organization and the partnership of which it is a member have different taxable years, the partnership items which enter into the computation of the organization's unrelated business taxable income must be based on the income and deductions of the partnership for the taxable year of the partnership which ends within the organization's taxable year. See Section 512(c)(2).



- (5) In *Service Bolt & Nut Co. v. Commissioner*, 724 F.2d 519 (6th Cir. 1983), the court considered whether amounts received from limited partnership interests constitute unrelated business taxable income. Qualified profit-sharing trusts exempt under Section 501(a) as organizations described in Section 401(a) received income from limited partnerships. The court cited Section 512(c), which provides that an exempt organization can be taxed on its share of the income received from a partnership of which it is a member, even though the partnership and not the exempt organization is the entity actively engaged in carrying on a trade or business. Refusing to distinguish between general partners and limited partners, the court concluded that income derived from limited partnership interests constitutes unrelated business taxable income. See also Rev. Rul. 79-222, 1979-2 C.B. 236.
- (6) Section 512(c) applies to any organization (such as an LLC) treated as a partnership for Federal tax purposes. See, for example, Rev. Rul. 2004-51, 2004-1 C.B. 974 (summarized above in Part II.C.1).
- (7) The term "unrelated business taxable income" doesn't include income from a limited partnership interest derived by certain testamentary trusts, if a number of highly restrictive conditions are met. For further details, see section 1951(b)(8) of the Tax Reform Act of 1976, Pub. L. No. 94-455.

## **J.1. Qualifying Partnership Interests Under Section 512(a)(6)**

- (1) As discussed above, an organization's investment activities are treated collectively as a separate unrelated trade or business for purposes of Section 512(a)(6). Investment activities include qualifying partnership interests.
- (2) Per the final regulations for tax years beginning on or after December 2, 2020, Treas. Reg. 1.512(a)-6(c)(8), the qualifying partnership interest rules don't apply to social clubs described in Section 501(c)(7). See Part IV of this document for a discussion of the UBTI of organizations subject to Section 512(a)(3), which includes social clubs.
- (3) A partnership interest, including an interest in a single partnership with multiple trades or business conducted directly or through lower-tier partnerships, is a qualifying partnership interest if it meets either the "de minimis test" or the 'participation test.' See Treas. Reg. 1.512(a)-6(c)(2)(i).
  - a. De minimis Test - A partnership interest generally meets the de minimis test if the exempt organization holds directly or indirectly no more than two percent of the profits interest and no more than two percent of the capital interest in the partnership.
  - b. Participation Test - A partnership interest generally meets the requirements of the participation test if the organization holds directly (within the meaning of Treas. Reg. 1.512(a)-6(c)(2)(i)) or indirectly (within the meaning of Treas. Reg. 1.512(a)-6(c)(2)(ii)(C)) no more than 20 percent of the capital interest during the organization's taxable year with which or in which the partnership's taxable year ends and the organization

doesn't significantly participate in the partnership within the meaning of Treas. Reg. 1.512(a)-6(c)(4)(iii). See Treas. Reg. 1.512(a)-6(c)(4)(ii) for rules regarding combining related interests.

- c. Significant Participation - An organization significantly participates in a partnership if: (i) the organization, by itself, may require the partnership to perform, or may prevent the partnership from performing, any act that significantly affects the operations of the partnership; (ii) any of the organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time; (iii) any of the organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; or (iv) the organization, by itself, has the power to appoint or remove any of the partnership's officers or employees or a majority of directors.
- (4) For purposes of the de minimis test and the participation test, an organization determines its percentage interest by taking the average of the organization's percentage interest at the beginning and the end of the partnership's taxable year, or, in the case of a partnership interest held for less than a year, the percentage interest held at the beginning and end of the period of ownership within the partnership's taxable year. See Treas. Reg. 1.512(a)-6(c)(5)(iii).
  - (5) In determining the exempt organization's percentage interest in a partnership, the exempt organization may rely on the Schedule K-1 it receives from the partnership if the form lists the organization's percentage profits interest or its percentage capital interest, or both, at the beginning and end of the year.
  - (6) A typical pooled investment fund is treated as a partnership for federal tax purposes therefore most interests in these funds apply the qualifying partnership interest rules to treat them as a single trade or business.
  - (7) Transition Rule: An organization may choose to apply the following transition rule if the partnership interest (acquired prior to August 21, 2018) doesn't meet either the de minimis test or participation test described above. An exempt organization may treat each such partnership interest as comprising a single unrelated trade or business for purposes of Section 512(a)(6) whether or not there is more than one trade or business directly or indirectly conducted by the partnership or lower-tier partnerships.

## **K. Special Rules for S Corporations**

- (1) Section 1361(c)(6) allows organizations described in Section 501(c)(3) or Section 401(a) and exempt from tax under Section 501(a) to own stock in an S Corporation without causing the corporation to lose its S Corporation status.
- (2) However, under Section 512(e), the items of income, deduction or loss that are considered to be distributed by the S Corporation to a shareholder that is a tax-exempt organization will in all cases be treated as unrelated business taxable income by the exempt organization, regardless of the source or nature of the income, deduction, or loss. In addition, any gain or loss on the disposition of the



S Corporation stock by the exempt organization will be treated as unrelated business taxable income.

## **L. Associate Member Dues**

- (1) Associate member dues are amounts paid to membership organizations by persons who may or may not receive all the rights and privileges afforded full members. Many organizations have long had various classes of members; however, associate membership became a significant issue in certain instances where exempt organizations created an associate (or limited benefit) member class in order for such individuals to qualify for insurance coverage, and their dues payments were essentially payments for such insurance. See *American Postal Workers Union, AFL-CIO v. United States*, 925 F.2d 480 (D.C. Cir. 1991), *National Association of Postal Supervisors v. Commissioner*, 944 F.2d 859 (Fed. Cir. 1991) and *National League of Postmasters of the United States v. Commissioner*, 86 F.3d 59 (4th Cir. 1996), all of which held that sponsoring and providing access to health insurance programs for associate or limited benefit members constitutes an unrelated trade or business. As discussed in Part II.A.3 of this document, an exempt organization's provision of services for a fee to full-fledged members related to the purchase of group insurance may be an unrelated business.
- (2) Rev. Proc. 95-21, 1995-1 C.B. 686, provides that dues payments from associate members of Section 501(c)(5) organizations won't be treated as gross income from the conduct of an unrelated trade or business unless the associate member category was formed or availed of for the principal purpose of producing unrelated business income. Rev. Proc. 97-12, 1997-1 C.B. 631, amplifies and modifies Rev. Proc 95-21 with two significant clarifying provisions. First, the newer revenue procedure discusses Section 512(d), which applies to the treatment of dues paid to Section 501(c)(5) agricultural or horticultural organizations (see below), and secondly, it extends the application of Rev. Proc. 95-21 to organizations described in Section 501(c)(6), such as business leagues, chambers of commerce, real estate boards and boards of trade.

## **M. Safe Harbor for Agricultural and Horticultural Organizations**

- (1) Section 512(d) provides a "safe harbor" from unrelated business taxable income for dues of \$100 or less, indexed for inflation, paid to Section 501(c)(5) agricultural or horticultural organizations. Under Section 512(d), if an organization requires the payment of annual dues and the amount of the dues doesn't exceed \$100, the dues won't be treated as derived from an unrelated trade or business. The statute provides that the \$100 dues ceiling will be indexed according to a cost-of-living adjustment for tax years beginning in a calendar year after 1995. Per Rev. Proc. 2022-38, for taxable years beginning in 2023, the limitation under Section 512(d)(1), regarding the exemption of annual dues required to be paid by a member to an agricultural or horticultural organization, is \$191. An annual revenue procedure is published with updated inflation-adjusted amounts. Per Rev. Proc. 2018-18, section 3.29 "dues" is

defined as any payment, whether or not specifically designated as dues, that is required to be made in order to be recognized as a member of the organization. See Section 512(d)(3).

## **N. Application of General Business Tax Credit**

- (1) In addition to the credits listed below, the Inflation Reduction Act of 2022, Public Law No. 117-169, also provides for a number of new credits generally relating to the promotion of clean energy and available to exempt organizations as well as other taxpayers. Under Section 6417, “any organization exempt from the tax imposed by subtitle A” may make an election with respect to an applicable credit to treat it as payment against tax. Under Section 6418, any taxpayer other than an applicable entity that makes the election under Section 6417 may sell its credit to an unrelated taxpayer.
- (2) The general business tax credit isn’t a single separate credit. Instead, it represents several specific tax credits that promote certain business activities as described below. The general business credit for the current year consists of the carryforward of business credits from prior years plus the total of the current year business credits. In addition, the general business credit for the current year may be increased later by the carryback of business credits from later years. The credit is subtracted directly from UBIT. See Section 38 and Form 3800, General Business Credit. The following credits are applicable to exempt organizations and meet the requirements of the general business tax credit.

### **N.1. Credit for Employer Share of FICA Taxes Paid (Section 45B)**

- (1) Section 45B(a) provides that, for purposes of Section 38, the employer social security credit is an amount equal to the “excess employer social security tax” paid or incurred by the taxpayer during the taxable year. The term “excess employer social security tax” means any tax paid by an employer under Section 3111 (both social security tax and Medicare tax) with respect to tips received by an employee to the extent (i) the tips are deemed to be paid by the employer pursuant to Section 3121(q) (without regard to whether the employees reported the tips to the employer pursuant to Section 6053) and (ii) the tips exceed the amount by which the wages (excluding tips) paid by the employer to the employee during such month are less than the total amount which would be payable (with respect to such employment) at the minimum wage rate.
- (2) When determining the amount of the “excess employer social security tax,” only tips received from customers in connection with providing, delivering, or serving food or beverages for consumption when tipping is customary shall be taken into account. See Section 45(B)(b)(2).
- (3) Employers may claim or elect not to claim the credit any time within three years from the due date of the tax return on either the original return or an amended return. The credit is a general business tax credit and is claimed on Form 8846, Credit for Employer Social Security and Medicare Taxes on Certain Employee Tips. Since it is an income tax credit claimed on an income tax return (for

example, Form 990-T), employers may use it to offset any income tax liability, but not employment tax liabilities. Employers can't claim both the Section 45B credit AND take an income tax deduction for any amount taken into account in determining the Section 45B credit. The Section 45B credit isn't refundable which means if the credit reduces the employer's income tax (UBIT) below zero, to a negative amount, the negative amount isn't sent as a tax refund. However, it is subject to carry back and carryforward provisions as described in Section 38.

- (4) In computing UBIT, it is proper for a social club described in Section 501(c)(7) to claim the credit under Section 45B for the portion of employer social security taxes paid with respect to employee tips received above the minimum wage amount from both members and nonmembers. These tips meet the requirements under Section 45B(b)(2) because the tips were received in connection with food and beverage service and tipping of employees is customary. Section 45B doesn't prohibit social clubs described in Section 501(c)(7) from claiming the credit, nor does it limit the credit to social security taxes paid in connection with a social club's unrelated trade or business. Therefore, a social club described in Section 501(c)(7) may calculate the Section 45B credit on the basis of all tips received by its employees, not only the tips received by employees from nonmembers. See Rev. Rul. 2003-64 2003-1 C.B. 1036.

## **N.2. Employer-provided Child Care Credit - Section 45F**

- (1) Employers use Form 8882, Credit for Employer-Provided Childcare Facilities and Services, to claim the credit for qualified childcare facility and resource and referral expenditures. For purposes of Section 38, the employer-provided childcare credit determined under this Section for the taxable years is an amount equal to the sum of:
  - a. 25 percent of the qualified childcare expenditures, and
  - b. 10 percent of the qualified childcare resource and referral expenditures of the taxpayer for such taxable year. See Section 45F(a).
- (2) The credit allowable under Section 45F(a) for any taxable year shall not exceed \$150,000. See Section 45F.

## **N.3. Tax Credit for Employee Health Insurance Expenses of Small Employers - Section 45R**

- (1) Section 45R offers a tax credit to certain small employers, including tax-exempt employers, that provide health insurance coverage to their employees (eligible small employer). The credit generally is available for taxable years beginning after December 31, 2009. For taxable years beginning after December 31, 2013, the credit is available only with respect to premiums paid by a small employer for a qualified health plan offered by the employer to its employees through a Small Business Health Options Program (SHOP) Exchange and is

available only for a period of two consecutive taxable years. Additionally, for taxable years beginning after December 31, 2013, the maximum credit rate is increased to 50 percent from 35 percent for eligible small employers and to 35 percent from 25 percent for tax-exempt eligible small employers. A tax-exempt eligible small employer may claim the credit by filing Form 990-T, Exempt Organization Business Income Tax Return and attaching Form 8941, Credit for Small Employer Health Insurance Premiums. The regulations provide guidance on determining eligibility for the credit and calculating and claiming the credit. See Treas. Reg. 1.45R-1 through -5.

#### **IV. Section 512(a)(3) – Computation of Unrelated Business Taxable Income for Social Clubs, Voluntary Employees Beneficiary Association, and Supplemental Unemployment Compensation Benefit Trusts**

- (1) Section 512(a)(3) provides special rules for certain exempt organizations to calculate their unrelated business taxable income (UBTI).

##### **A. Overview**

- (1) The following organizations must calculate their UBTI under Section 512(a)(3) rather than Section 512(a)(1):
  - a. Social clubs (described in Section 501(c)(7)),
  - b. Voluntary employees' beneficiary associations (VEBAs) (described in Section 501(c)(9)), and
  - c. Supplemental unemployment compensation benefit trusts (SUB trusts) (described in Section 501(c)(17)).
- (2) Organizations that must calculate their unrelated business income under Section 512(a)(3) are taxed on all income that isn't "exempt function income." Thus, such organizations are taxed on income from outside their membership and on investment income. Congress explained the special UBTI rule as follows (H.R. Rep. No. 91-413 Pt. 1 p. 48 (Aug. 2, 1969)):
  - a. "Since the tax exemption for social clubs, for example, is designed to allow individuals to join together to provide recreational or social facilities on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit not contemplated by the

exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation to its membership.”

- (3) In general, Section 512(a)(3) provides rules for determining the UBIT of social clubs, voluntary employees' beneficiary associations and SUB trusts. Under Section 512(a)(3)(A), UBTI of a social club, VEBA, or SUB trusts means all income except exempt function income, less the deductions allowed by Chapter 1 of the Code which are directly connected with the production of the gross income.
- (4) In general, under Section 512(a)(3)(B), gross income from members is considered exempt function income if it is paid by members as consideration for providing such members, their dependents (as defined in Section 152), or guests with goods, facilities or services in furtherance of the exempt purposes of the organization. Exempt function income also includes income that is set aside for purpose specified in Section 170(c)(4) or in the case of an organization described in Section 501(c)(9) or 501(c)(17) to provide for the payment of life, sick, accident or other benefits, subject to certain limitations on the amounts set-aside.

## **B. Calculation of Unrelated Business Taxable Income**

- (1) Generally, UBTI under Section 512(a)(3)(A) is calculated in the following manner:
  - a. All gross income, (excluding exempt function income),
  - b. Less deductions allowed by Chapter 1 of the Code which are directly connected with the production of gross income (excluding exempt function income), both computed with
  - c. Modifications for net operating losses as described in Section 512(b)(6), charitable contributions under Section 512(b)(10) or Section 512(b)(11), and the standard \$1,000 deduction under Section 512(b)(12).

### **B.1. Gross Income**

- (1) In calculating unrelated business income under Section 512(a)(3)(A), gross income needs to be determined initially. Gross income is all income to the organization.
- (2) Rev. Rul. 76-337, 1976-2 C.B. 177 holds that interest on obligations of a state received by a social club exempt under Section 501(c)(7) isn't included in its gross income for the purpose of computing UBTI under Section 512(a)(3), based on the exclusion from gross income provided under Section 103(a).

### **B.2. Exempt Function Income**

- (1) Exempt function income includes:
  - a. Amounts derived from dues, fees, charges, or similar amounts of gross income from members, and

- b. Set-aside income.
- (2) Treas. Reg. 1.512(a)-5 provides special rules for the computation of UBTI of VEBA and SUB trusts (referred to in the regulations as a “Covered Entity”). Treas. Reg. 1.512(a)-5(b)(2) provides that the exempt function income of a Covered Entity is the sum of:
- a. Amounts referred to in the first sentence of Section 512(a)(3)(B) that are paid by members of the Covered Entity and employer contributions to the Covered Entity (collectively “member contributions”),
  - b. Other income of the Covered Entity (including earnings on member contributions) that is set aside for a purpose specified in Section 170(c)(4) and reasonable costs of administration directly connected with such purpose, and
  - c. Other income of the Covered Entity (including earnings on member contributions) that, subject to the limitation of Section 512(a)(3)(E) (as described in Treas. Reg. 1.512(a)-5(c)), is set aside for the payment of life, sick, accident, or other benefits and reasonable costs of administration directly connected with such purpose. See Treas. Reg. 1.512(a)-5(b)(1).

### **B.3. Gross Income from Members**

- (1) Gross income from members is considered exempt function income if it is paid by members as consideration for providing such members, their dependents (as defined in Section 152), or guests with goods, facilities, or services in furtherance of the exempt purposes of the organization. See Section 512(a)(3)(B). These items of gross income include:
- a. Dues,
  - b. Fees,
  - c. Charges, or
  - d. Similar amounts paid by members.
- (2) Examples of gross income from members (exempt function income) include:
- a. Income derived by a social club from members of the club for use of the club’s golf course. See H.R. Rep. No. 91-413 (Part 2), 91st Cong., 1st Sess. 23 (1969), 1969-3 C.B. 353.
  - b. Amounts paid by a social club member’s spouse or by a member for his or her dependent. See Rev. Proc. 71-17, Section 2.01.
  - c. Amounts paid for the benefit of a social club member by the member’s employer for a use that serves a direct business objective of the employee-member solely for purposes of section 3.03(1) and 3.03(2). See Rev. Proc. 71-17, Section 3.03(3).



## B.4. Set Asides

- (1) Set-aside income is classified as exempt function income. See Section 512(a)(3)(B). It is income derived by an organization which is set aside for either of the following purposes (including the reasonable administration costs directly connected with such purpose):
  - a. for a purpose specified in Section 170(c)(4) (religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals); or
  - b. in the case of Section 501(c)(9) or (17) organizations, to provide for the payment of life, sick, accident, or other benefits.
- (2) If in any year an amount attributable to income set aside is used for any other purpose than those described in Section 512(a)(3)(B)(i) or (ii), then this amount is subject to the UBIT. See Section 512(a)(3)(B).
- (3) Gross income from an unrelated trade or business described in Section 512(a)(1) can't be set aside as exempt-function income. See Section 512(a)(3)(B).
- (4) National organizations of college fraternities and sororities often set aside income for various activities such as:
  - a. Scholarships,
  - b. Student loans, and
  - c. Leadership and citizenship schools and services.
- (5) Prop. Reg. 1.512(a)-3 (36 FR 8808, May 13, 1971), later withdrawn (52 FR 2724, Jan. 26, 1987), provided that set-aside income may be temporarily invested or accumulated (as long as the amount and duration aren't unreasonable), provided that it's earmarked or placed in a separate account. This provision has long appeared in the Form 990-T instructions. *Phi Delta Theta Fraternity v. Commissioner*, 887 F.2d 1302 (6th Cir. 1989), applying the provisions of Treas. Regs. 1.512(a)-4 and 1.642(c)-2 to define a proper set-aside, held that funds used to pay the costs of the fraternity's publication (even if it had been educational) from an endowment fund weren't properly set aside because the fund could be used for non-charitable purposes of the fraternity. See also *Confrerie de la Chaine des Rotisseurs v. Commissioner*, T.C. Memo. 1993-637.
- (6) The above-referenced withdrawn proposed regulation also provided that set-aside income may be excluded from gross income only in the taxable year in which it's includible in gross income, except that a taxpayer may set aside amounts of gross income from a prior taxable year to the extent that such amounts could have been set aside and are actually set aside on or before the date prescribed for filing the Exempt Organization Business Income Tax Return (Form 990-T). This provision has also long appeared in the Form 990-T instructions and in Pub. 598.

- (7) **Example:** Assume that X, a social club described in Section 501(c)(7), received \$5,000 in dividend income which is includible in gross income in X's taxable year ending December 31, 2017, on account of Section 512(a)(3). Also, assume that X must file its Form 990-T for taxable year 2017 by May 15, 2018. In this case, X may elect to treat the \$5,000 as a set-aside on its 2017 Form 990-T if it sets aside such amount no later than May 15, 2018.
- (8) Section 512(a)(3)(E) provides an amount won't be considered set aside for purposes of Section 512(a)(3)(B)(ii) to the extent it exceeds the account limit of Section 419A(c) for life, medical, supplemental unemployment, severance, or disability benefits, except that under Section 512(a)(3)(E)(ii)(I), the limitation doesn't apply to existing reserves for post-retirement medical benefits or post-retirement life insurance benefits. The effect of this provision is to tax Section 501(c)(9) and (17) organizations on their investment income to the extent their asset accounts under Section 419A are overfunded. See Treas. Reg. 1.512(a)-5(c)(1).
- (9) A VEBA may not avoid the limitation on exempt function income in Section 512(a)(3)(E)(i) merely by allocating, or purporting to allocate, investment income toward the payment of welfare benefits during the course of the tax year. See Treas. Reg. 1.512(a)-3(c)(2)(i) and *Northrop Corp. Employee Ins. Benefit Plans Master Trust v. U.S.*, 99 Fed.Cl. 1 (2011).
- (10) In *Sherwin-Williams Co. Employee Health Plan Trust v. Comm'r*, 330 F.3d 449 (6th Cir. 2003), the Court of Appeals for the Sixth Circuit concluded Section 512(a)(3)(E) limits how much the VEBA may accumulate, not how much may be set aside. The court held that Section 512(a)(3)(E)(i)'s limit on accumulating set-aside income doesn't apply to income that was set aside and spent on the reasonable costs of administering health care benefits under Section 512(a)(3)(B), and that such spent income is exempt function income, not subject to tax under Section 512(a)(3)(A). This was contrary to the interpretation the IRS and Treasury maintained. *Sherwin-Williams* remained precedent for taxpayers in the 6<sup>th</sup> Circuit until IRS and Treasury issued final regulations. The IRS issued final regulations on this issue that were effective December 10, 2019. See Treas. Reg. 1.512(a)-5. Based on the final regulations, IRS will continue to interpret Section 512(a)(3)(E)(i) to mean that whether a Section 501(c)(9) organization or Section 501(c)(17) organization allocated its investment income (rather than other funds) to current year expenditures is irrelevant to the application of the set aside limitation.

## B.5. Allowable Deductions

- (1) A deduction allowable under Chapter 1 of the Code will only be taken into account in computing UBTI under Section 512(a)(3) if it is directly connected with the production of gross income (excluding exempt function income). Personnel expenses used both for an exempt purpose and for the production of



gross income (excluding exempt function income) shall be allocated between the two uses on a reasonable basis. See Treas. Reg. 1.512(a)-1(c).

- (2) **Example:** Assume that X, an exempt organization subject to the provisions of Section 511, pays its manager a salary of \$10,000 a year and that it derives gross income from the conduct of unrelated trade or business activities. If the manager devotes 10 percent of his/her time during the year the unrelated business activity), a deduction of \$1,000 (10 percent of \$10,000) would be allowable for purposes of computing X's UBTI.
- (3) In *Chicago Metropolitan Ski Council v. Commissioner*, 104 T.C. 341 (1995), the Tax Court held that the special rules for the computation of UBTI from periodical advertising under Treas. Reg. 1.512(a)-1(f) apply to social clubs. Thus, a deduction from advertising income is allowed for excess readership costs (expenses related to the editorial content of a publication), as discussed in Part III.D of this document.
- (4) In *Rolling Rock Club v. United States*, 785 F.2d 93 (3rd Cir. 1986), the court held that a Section 501(c)(7) social club wasn't entitled to claim the dividends received deduction under Section 243 against its investment income. The court observed that Section 512(a)(3)(A) was amended in 1976 to provide that, for purposes of determining the UBTI and the allowable deductions therefrom, the deductions provided by Sections 243 and 245 (relating to dividends received by corporations) shall be treated as not directly connected with the production of income.
- (5) In *South End Italian Independent Club, Inc. v. Commissioner*, 87 T.C. 168 (1986), acq. in result, 1987-2 C.B. 1, AOD-1987-15 (June 15, 1987), the court held that a Section 501(c)(7) social club, which distributed its net proceeds from the operation of beano (bingo) games in accordance with state law requirements, wasn't subject to the charitable contribution deduction limitations imposed by Section 512(b)(10), because the proceeds were deductible as ordinary and necessary business expenses under Section 162, rather than as charitable contributions under Section 170.
- (6) In *Ye Mystic Krewe of Gasparilla v. Commissioner*, 80 T.C. 755 (1983), a Section 501(c)(7) social club staged a "mock invasion" of a city which was followed by a parade. The club owned the concession rights along the parade route and negotiated contracts with others to provide seats and refreshments. The club received a percentage of the net receipts from these concessions, as well as amounts derived from the sale of logbooks and from the sale of advertising contained in them. The court held that the club's gross income from the concessions and the sales of logbooks was UBTI under Section 512(a)(3)(A), and that the expenses of staging the invasion and parade weren't directly connected with the production of income from the concessions and logbooks.

## B.6. Deductions Against Investment Income

- (1) Rev. Rul. 81-69, 1981-1 C.B. 351 discusses a Section 501(c)(7) social club that has UBTI from investments made for profit. The club also sells food and beverages to nonmembers at prices insufficient to recover the costs of such sales. Sales of food and beverages to nonmembers have consistently over a number of years resulted only in losses, which are expected to continue. Applying Section 512(a)(3)(A), the revenue ruling holds that because the club's sales of food and beverages to nonmembers aren't profit motivated, the club may not deduct losses from sales to nonmembers from its net investment income.
- (2) In *Portland Golf Club v. Commissioner*, 497 U.S. 154 (1990), the Court held that a Section 501(c)(7) social club was required to demonstrate an intent to earn gross receipts in excess of both variable and fixed costs to show an intent to profit. The case required the Court to determine whether the club, in calculating its liability for Federal income tax, may offset losses incurred in selling food and drink to nonmembers against the income realized from its investments. The club had sustained losses on sales to nonmembers for ten years. The Court held that the club was allowed to offset investment income by losses incurred in sales to nonmembers only if those sales were motivated by an intent to profit. The Court further held that an intent to profit is determined by using the same method to allocate fixed costs to nonmember sales as that used to compute the club's actual profit or loss. In applying this standard, the Court determined that Portland failed to show that it had intended to earn gross income from nonmember sales in excess of its total cost. Therefore, the club lacked the requisite profit motive with regard to nonmember sales. The Court analyzed Section 512(a)(3)(A) and viewed the inclusion of the phrase "allowed by this chapter" as limiting deductions of expenses to those described in Chapter 1. Thus, only deductions that meet the criteria of Section 162(a) are permitted. Under Section 162(a), expenses must be incurred in connection with a "trade or business." The Court noted that to disregard the profit-motive requirement would run counter to the principle of tax neutrality underlying the statutory scheme (discussed in Part IV.A(2) of this document). See also the discussion in Part II.A of this document.
- (3) See also *Losantiville Country Club v. Commissioner*, T.C. Memo. 2017-158, *aff'd* by 906 F.3d 468 (6th Cir. 2018).
- (4) Note that post-2017, Section 512(a)(6) requires siloing of unrelated businesses for purposes of offsetting losses from one unrelated business (including an investment activity) against net income from another, as discussed in Part III.G of this document. Section 512(a)(6) applies to Section 501(c)(7), (9), and (17) organizations as well as other exempt organizations, subject to certain special rules for the treatment of investment activities in Treas. Reg. 1.512(a)-6, as discussed in Part III.G.2(4) of this document.

## C. Treatment of Title Holding Companies

- (1) Section 512(a)(3)(C) provides that when the income of an exempt holding company (described in Section 501(c)(2)) is payable to an exempt organization which is described in Section 501(c)(7), (9), or (17), the holding company is to be treated as if it were the organization to which its income is payable. Thus, if the income of a holding company is payable to a social club or a VEBA, the holding company will be subject to tax as if it were a social club or a voluntary employees' beneficiary association. However, the holding company won't be treated as having exempt function income unless it files a consolidated return with the payee organization.

## D. Gain on Sale of Assets

- (1) The sale of property is taxable under Section 512(a)(3)(A) unless the sale satisfies the nonrecognition requirements of Section 512(a)(3)(D). If the requirements of Section 512(a)(3)(D) are satisfied, then an organization may exclude all or a portion of the gain from the sale of property.
- (2) Requirements for an organization to exclude gain under Section 512(a)(3)(D):
  - a. A sale of property.
  - b. The property is used directly in the performance of an organization's exempt function.
  - c. New property is purchased by the organization.
  - d. The new property is used directly in the performance of an organization's exempt function.
  - e. The new property is purchased within a four-year period, beginning one year before the date of the sale of the old property and ending three years after the sale.
  - f. The new property purchased need not be similar in nature or in use to the property sold. See *Tamarisk Country Club v. Commissioner*, 84 T.C. 756, 758 n. 2. (1985).
  - g. Gain (if any) from the sale is recognized only to the extent that the sales price of the old property exceeds the cost of the new property. The recognized gain is includible in the organization's gross income in the year in which the gain is realized. Rules similar to subsections (b), (c), (e), and (j) of Section 1034 (relating to rollover of gain on sale of principal residence, immediately before its repeal in 1997) apply. See former Section 1034(j) and former Treas. Reg. 1.1034-1(i)(1) (1997) for an extended limitations period for the assessment of any tax deficiency on such gain.
  - h. The recognized gain is includible in the organization's gross income in the year in which the gain is realized.

- i. **Example:** A social club sells its clubhouse. The gain on the sale won't be taxed if the entire proceeds are reinvested in a new clubhouse within three years. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 72 (1969), 1969-3 C.B. 470.

## E. Direct Use

- (1) There is no definition of what is considered "used directly" in the performance of an organization's exempt function for purposes of Section 512(a)(3)(D). Examples of property that are directly used, include but aren't limited to:
  - a. Golf course (see PLR 200826038 (Apr. 4, 2008))
  - b. Club house (see id.)
  - c. Timber cut on a hunting or fishing club's property (see TAM 9541002 (Feb. 3, 1995))
- (2) *Atlanta Athletic Club v. Commissioner*, 980 F.2d 1409 (11th Cir. 1993) addressed the issue of whether property is used directly in performance of its exempt function.
  - a. Facts: The club owned a piece of property which has a slag road for members and guest parking. A pine jogging track was built on the property but later abandoned. Club members testified that the property was the site of a number of member activities such as pasture parties, Easter egg hunts, fishing tournaments, kite flying contests, hot air balloon rides and organized foot races. Members jogged on the property, used it for archery practice and flew model airplanes.
  - b. Holding: The court looked at the record and saw nothing to contradict the club's evidence that the property was used for recreational purposes. Direct use isn't to be equated with dominant use or requiring that direct use have either continuity or regularity. Direct use is to be determined by looking at the activities that took place on the property and determining whether these activities constitute recreational uses by the club. Organizations need to keep records that provide details concerning the use of the property to prove that the property sold furthered their exempt purposes.
- (3) The Tax Court in *Deer Park Country Club v. Commissioner*, T.C. Memo. 1995-567, stated that land subject to Section 512(a)(3)(D) must actually be used for exempt functions prior to the sale.
  - a. Facts: A country club purchased two tracts of land, one used for fishing and one as a golf course. It subsequently transferred the fishing property to the state of Illinois for cash and a 63.8-acre tract of farmland. The farmland was rented from 1981 to 1986, and during that time, the club engaged a designer to develop plans for constructing an additional golf course, a swimming pool, and tennis courts. After consulting with banks

regarding financing, the club decided to devote 59 acres for recreational purposes and to subdivide and sell the remaining 4.8 acres.

- b. Holding: Section 512(a)(3)(D) requires a use of assets or property that is both actual and direct in relation to the performance of its exempt function. The intention of using property in furtherance of exempt purposes is irrelevant. Although the club may have originally intended to use all of the land for recreational purposes, the fact that the club never used the 4.8 for exempt purposes was dispositive. The club's gain on the 4.8 acres was therefore subject to UBIT.
- (4) In *Framingham Country Club v. United States*, 659 F. Supp. 650 (D. Mass. 1987), the court held a Section 501(c)(7) social club couldn't use the nonrecognition of gain provision under Section 512(a)(3)(D) with respect to income received from an option on the sale of property. In the court's view, the lapse of an option is to be treated as ordinary income to the grantor and not as short-term capital gain resulting from a "sale." An alternative adverse holding made by the court was that the club hadn't sufficiently demonstrated that the property was used directly in the performance of the club's exempt function as required by Section 512(a)(3)(D). The court noted that although the property may have been originally purchased with the intention of providing golfing facilities, it was never used for that purpose. The use of a home for a greenskeeper and the storage of large equipment on the property didn't directly facilitate the club's exempt function.
  - (5) In *Tamarisk Country Club v. Commissioner*, 84 T.C. 756 (1985), the court held that the gain realized by a Section 501(c)(7) social club from the sale of real property was fully recognized as UBTI because the club's sales price less selling expenses exceeded the cost of the new property by more than the amount of gain realized on the sale. The court rejected the club's argument that it was entitled to nonrecognition of gain to the extent its equity or profit was reinvested in other qualifying property.

## **V. Debt-Financed Property Under Section 514**

- (1) This section discusses the rules expanding the definition of unrelated business income to include unrelated debt-financed income from investment property in proportion to the degree of indebtedness on the property (measured as a percentage of the property's average adjusted basis). Property purchased with borrowed money (acquisition indebtedness) and held to produce investment income is referred to as debt-financed property. Various types of passive income constitute unrelated business taxable income if:
  - a. The income arises from property acquired or improved with borrowed funds, and

- b. The production of income is unrelated to the purpose constituting the basis of the organization's tax exemption.

## A. Overview

- (1) Rents from real property traditionally have been excluded from the statutory definition of UBTI. See Section 512(b)(3). To avoid an abuse of this exclusion, the Revenue Act of 1950 included "business lease" provisions which provided, in general, that long-term rentals from real property would be taxed to the extent of the indebtedness on the property.
- (2) The necessity for Section 514 arose because a large number of tax-exempt organizations bought businesses and investments on credit, frequently at greater than the market price, while contributing little or nothing to the transaction other than their tax exemption. In a typical transaction, a corporate business was sold to a Section 501(c)(3) organization, which paid little or no money down, and agreed to pay the balance of the purchase price out of profits from the property. The exempt organization next liquidated the corporation and leased the business assets back to the seller. The seller then formed a new corporation to operate the business. The newly formed corporation paid a large portion of its business profits as rent to the exempt organization, which then paid most of these profits back to the original owner as installment payments on the original purchase price. In the well-known Clay Brown case (*Commissioner v. Brown*, 380 U.S. 513 (1965)), a business was able to realize increased after-tax income, and the exempt organization acquired the ownership of a business valued at \$1.3 million without the investment of its own funds. The tax results of this transaction under pre-1969 law provided a capital gain to the seller, a rent deduction for the operator, and no tax on the tax-exempt organization, similar to the arrangement described above. See H.R. Rep. 91-413, 91st Cong., 1st Sess., reprinted at 1969-3 C.B. 200, 229 and S. Rep. 91-552, 91st Cong., 1st Sess., reprinted at 1969-3 C.B. 423, 464.
- (3) Congress remedied this situation by including in the Tax Reform Act of 1969 a provision which imposes the unrelated business income tax on all types of passive unrelated income from income-producing debt-financed property. This differs from the "business lease" provisions that only taxed "rentals from real property." To further strengthen this measure, Congress expanded the categories of exempt organizations subject to UBIT to include all organizations exempt under Section 501(a) other than organizations described in Section 501(c)(1).
- (4) The Supreme Court has stated that the undisputed purpose of UBIT is to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed. See *U.S. v. American Bar Endowment*, 477 U.S. 105, 114 (1986) and *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986). The House Report on Section 514 also indicated a purpose to eliminate the incentive for owners desiring to sell a business to exploit the tax exemption of nonprofit organizations, with its damaging consequences to the

Federal revenues. H.R. Rep. No 413 (Pt. 1), 91st Cong., 1st Sess. 46 (Aug. 2, 1969).

- (5) Under Section 514(a), unrelated debt-financed income that would otherwise be excluded from an exempt organization's UBTI must be included to the extent it is derived from debt-financed property. See Debt-financed Income Lead Sheet (Exhibit X.G of this document).
- (6) Under Section 514(b), the term "debt-financed property" generally means any property held to produce income (including gain from its disposition) and with respect to which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal if it was disposed of during the tax year). It includes rental real estate, tangible personal property, and corporate stock. The calculation of debt-financed taxable income is made on a property-by-property basis. See Treas. Reg. 1.514(b)-1(a).
- (7) Under Section 512(b)(4), in the case of debt-financed property, an exempt organization must include, as an item of gross income from an unrelated trade or business, any unrelated debt-financed income determined under Section 514 with respect to such debt-financed property, even if an amount received with respect to the debt-financed property would ordinarily be excluded from the calculation of UBTI under Section 512(b)(1), (2), (3), or (5). The amount of income included is proportionate to the debt on the property.
- (8) Under Section 512(b)(1), (2), (3), and (5), the amounts that are included in UBTI if subject to acquisition indebtedness include dividends, interest, annuities, royalties, rents, and capital gains. These generally are income from investment activities. Moreover, Section 514 generally doesn't apply to any property to the extent that the income from such property is taken into account in computing the gross income of any unrelated trade or business (except in the case of capital gains from such property that would be excluded under Section 512(b)(5)). See Section 514(b)(1)(B).
- (9) In some circumstances, rental of real property is an unrelated trade or business that must be identified using NAICS 2-digit codes which were discussed earlier in this document in Part III.G.1. For example, Section 512(b)(3)(B) provides that rents from real and personal property are included in UBTI if more than 50 percent of the total rent received or accrued under a lease is attributable to personal property. Section 512(b)(4) and Section 514 don't apply where such real or personal property is purchased with debt financing because the rents from these properties will have already been included in UBTI. See Section 514(b)(1)(B) and Treas. Reg. 1.514(b)-1(b)(2)(i). Accordingly, because rent from such real and personal property is included in UBTI, the exempt organization must identify such unrelated trade or business using the NAICS 2-digit code for real estate rental and leasing (NAICS code 53) Note: The NAICS business activity codes are updated every 5 years. See [www.census.gov](http://www.census.gov). By contrast, if the rents were included in UBTI solely as unrelated debt-financed



income, then the debt-financed property would be treated (together with other investment activities) as a single trade or business, except in the case of Section 501(c)(7) social clubs. See Treas. Reg. 1.512(a)-6(c)(1) and (7) and Part III.G of this document.

## B. Formula for Unrelated Debt-Financed Income

- (1) The primary components for figuring unrelated debt-financed gross income under the formula announced in Treas. Reg. 1.514(a)-1(a)(1)(ii) are:
  - a. Average acquisition indebtedness,
  - b. Average adjusted basis, and
  - c. Gross income derived during the taxable year from or on account of the debt-financed property.
- (2) The formula for deriving "unrelated debt-financed income" is:

Unrelated Debt Financed Income Formula		
$\frac{\text{Average Acquisition Indebtedness}}{\text{Average Adjusted Basis}}$	$\times$	$\text{Gross Income from Debt Financed Property} = \text{Unrelated Debt Financed Income}$

- (3) The initial fraction in the formula is the debt/basis percentage. See Treas. Reg. 1.514-1(a)(1)(iii). The percentage of income treated as income from an unrelated trade or business decreases as the indebtedness on the debt-financed property decreases.
  - a. **Example:** X, an exempt trade association, owns an office building which is debt-financed property. The building in 1971 produces \$10,000 of gross rental income. The average adjusted basis of the building for 1971 is \$100,000, and the average acquisition indebtedness with respect to the building in 1971 is \$50,000. Accordingly, the debt/basis percentage for 1971 is 50% (the ratio of \$50,000 to \$100,000). Therefore, the unrelated debt-financed income with respect to the building for 1971 is \$5,000 (50% of \$10,000). See Treas. Reg. 1.514(a)-1(a)(iv).

## C. Allocation

- (1) Section 514(e) provides that where only a portion of property is debt-financed property, proper allocation of the basis, indebtedness, income, and deductions with respect to such property must be made to determine the amount of income or gain derived from such property that will receive treatment as unrelated debt-financed income. See Treas. Reg. 1.514(b)-1(b)(1)(iii), Treas. Reg. 1.514(b)-1(b)(3) and Part V.J.1(7) of this document.



## D. Gain from Sale or Other Disposition of Property

- (1) Under Treas. Reg. 1.514(a)-1(a)(1)(v), if an organization sells or otherwise disposes of debt-financed property, it must include in computing unrelated business taxable income an amount with respect to any gain (or loss) which is the same percentage (not over 100%) of the total gain (or loss) derived from the sale as:
  - a. The highest acquisition indebtedness with respect to such property during the 12-month period preceding the date of disposition, is of
  - b. The average adjusted basis of such property.
- (2) Treas. Reg. 1.514(a)-1(a)(1)(v) provides that the tax on this amount is determined in accordance with the rules regarding capital gains and losses in Subchapter P, chapter 1 of the Code.
- (3) However, Rev. Rul. 77-71, 1977-1 C.B. 155, provides that the transfer, subject to an existing mortgage, of an appreciated building by a tax-exempt organization to its wholly-owned taxable subsidiary, in a manner that satisfies the nonrecognition provisions of Section 351(a), doesn't result in a gain for which the exempt organization making the transfer will be taxed under Section 511.

## E. Deductions

- (1) Under Section 514(a)(2), the deductions allowed with respect to each debt-financed property are determined by applying the debt/basis percentage to the sum of the deductions allowable.
- (2) The deductions allowable are those items allowed as deductions by chapter 1 of the Code which are directly connected with the debt-financed property or income therefrom (including the dividends received deductions allowed by Sections 243 and 245), except that:
  - a. The allowable deductions are subject to the modifications provided by Section 512(b) on computation of UBTI, and
  - b. The depreciation deduction under Section 167 is computed only by use of the straight-line method. See Treas. Reg. 1.514(a)-1(b)(2).
- (3) To be "directly connected with" debt-financed property or the income therefrom, an item of deduction must have a proximate or primary relationship to such property or income. Expenses, depreciation, and similar items attributable solely to such property qualify for deduction to the extent they meet the above requirements. See Treas. Reg. 1.514(a)-1(b)(3).
- (4) **Example:** If the straight-line depreciation allowance for an office building is \$10,000 a year, an organization would be allowed a deduction for depreciation of \$10,000 if the entire building were debt-financed property. However, if only half of the building were treated as debt-financed property, the depreciation allowed as a deduction would be \$5,000. See Treas. Reg. 1.514(a)-1(b)(3).

## F. Losses

- (1) If the sale or exchange of debt-financed property results in a capital loss, the amount of such loss taken into account in the taxable year in which the loss arises is computed in determining the gain (or loss) from the sale or other disposition of the property. If any part of a loss may be carried back, or forward to another taxable year, it is taken as a deduction for that year without further application of the debt/basis percentage for such year. See Treas. Reg. 1.514(a)-1(b)(4)(i).
- (2) **Example:** X, an exempt educational organization, owns securities which are capital assets and which it has held for more than 6 months. In 1972 X sells the securities at a loss of \$20,000. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the securities is 40 percent. Thus, X has sustained a capital loss of \$8,000 (40 percent of \$20,000) with respect to the sale of the securities. For 1972 and the preceding three taxable years X has no other capital transactions. Under these circumstances, the \$8,000 of capital loss may be carried over to the succeeding 5 taxable years without further application of the debt/basis percentage.

### F.1. Net Operating Loss

- (1) Under prior law, organizations could carry back and carry forward net operating losses from activities generating unrelated business taxable income under Section 511. In enacting Section 512(a)(6), Congress drastically changed how unrelated business taxable income is computed and how losses from unrelated business taxable activities may be utilized. Congress also provided transition rules for losses generated prior to December 31, 2017. The critical concept to remember in implementing Section 512(a)(6) is the idea of “siloing.” That is, in computing unrelated business taxable income, each unrelated trade or business is computed separately based on the applicable NAICS code, and the gains or losses from each trade or business aren’t aggregated. This prevents losses from certain unrelated trade or business activities from offsetting income from other unrelated trade or business activities. See Treas. Reg. 1.512(a)-6(a), (b), and (h). If income from debt-financed properties is included in UBTI solely as unrelated debt-financed income, then the debt-financed properties would be treated together, along with other investment activities, as a single trade or business for purposes of Section 512(a)(6). See Treas. Reg. 1.512(a)-6(c)(1) and (7) and Part III.G of this document.
- (2) If, after applying the debt/basis percentage to the income and deductions from debt-financed property, the deductions exceed such income, and there is no other source of income within the same trade or business, an organization has a net operating loss for the taxable year. This amount may be carried forward with its investment activities trade or business NOL to other taxable years in accordance with Section 512(b)(6). However, the debt/basis percentage isn’t applied in such other taxable years to determine the amounts that may be taken as deductions in those years. See Treas. Reg. 1.514(a)-1(b)(5).

- (3) **Example:** A property is debt-financed. During the taxable year, Y, an exempt organization, receives \$20,000 of rent from a building which it owns. Y has no other unrelated business taxable income for the year. The deductions directly connected with this building are property taxes of \$5,000, interest of \$5,000 on the acquisition indebtedness, and salary of \$15,000 to the manager of the building. The debt/basis percentage of the taxable year with respect to the building is 50%. Under these circumstances, Y must take into account in computing its unrelated business taxable income for the taxable year, \$10,000 of income (50% of \$20,000) and \$12,500 (50% of \$25,000) of the deductions directly connected with such income. Thus, for the year, Y has sustained a net operating loss of \$2,500 (\$10,000 of income less \$12,500 of deductions) which may be carried forward to other taxable years without further application of the debt/basis percentage. Remember, as mentioned earlier the loss would be siloed based on the unrelated trade or business activity and applicable NAICS code or if it was from an investment the appropriate code for those activities. See Treas. Reg. 1.514(a)-1(b)(5)(ii) and Treas. Reg. 1.512(a)-6(a), (b), and (h) and the Instructions to the Form 990-T.

## G. Average Adjusted Basis

- (1) The "average adjusted basis" of debt-financed property is the average amount of the adjusted basis of such property during that portion of the taxable year in which it is held by an organization. It is computed by averaging the adjusted basis as of the first day and as of the last day during the taxable year in which the organization holds the property. (Refer to Section 1011 and the Regulations thereunder for determination of the adjusted basis of property.) See Treas. Reg. 1.514(a)-1(a)(2)(i).
- (2) The average adjusted basis of debt-financed property isn't affected by the fact that an organization was exempt from tax for prior taxable years. Adjustment must be made under Section 1011 for the entire period beginning with the acquisition of the property. See Treas. Reg. 1.514(a)-1(a)(2)(ii).
- (3) For example, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from tax. See Section 1016(a)(3)(B). The fact that only a portion of the depreciation allowance may be taken into account in computing the percentage of deductions allowable under Section 514(a)(2) doesn't affect the amount of the adjustment for depreciation which is used in determining average adjusted basis. See Treas. Reg. 1.514(a)-1(a)(2)(ii).

### G.1. Basis of Property Acquired in a Corporate Liquidation

- (1) Under Section 514(d), if debt-financed property is acquired by an exempt organization in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in such property is the same as it would be in the hands of the transferor corporation. This basis is increased by the amount of gain recognized to the transferor corporation upon such distribution (see

Section 337(d) and Treas. Reg. 1.337(d)-4) and by the amount of any gain to the organization, which is includible, on account of such distribution, as UBTI pursuant to Section 514(a).

## H. Acquisition Indebtedness

- (1) Section 514(c) defines acquisition indebtedness as the outstanding amount of indebtedness incurred before, during or after the acquisition or improvement. In the case of indebtedness incurred before or after, acquisition indebtedness exists only if the indebtedness wouldn't have been incurred but for such acquisition or improvement. See Section 514(c)(1)(B) and (C).
- (2) In the case of indebtedness incurred after the acquisition or improvement, acquisition indebtedness exists only if such indebtedness was also reasonably foreseeable at the time of such acquisition or improvement. See Section 514(c)(1)(C).
- (3) The facts and circumstances of each situation determine whether incurring a debt was reasonably foreseeable. That an organization may not have foreseen the need to incur a debt before acquiring or improving the property doesn't necessarily mean that incurring the debt later wasn't reasonably foreseeable. See Treas. Reg. 1.514(c)-1(a)(1).
- (4) **Example:** Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building that Y rents to an insurance company for nonexempt purposes. The debt is acquisition indebtedness since the debt, though incurred after the improvement of the office building, wouldn't have been incurred without the improvement, and the debt was reasonably foreseeable when, to make the improvement, Y reduced its working capital below the amount necessary to continue current operations. See Example 2, Treas. Reg. 1.514(c)-1(a)(2).
- (5) There are also several factors that need to be considered before determining the amount of debt-financed income, including the income from the property, the cost of the property, and the amount of the liability.
- (6) The amount of income subject to UBIT is the unrelated debt-financed income. As discussed in (A), above, this value is derived from calculating the "average acquisition indebtedness," the "average adjusted basis" and the gross income from the debt-financed property. See Section 514(a)(1).

### H.1. Average Acquisition Indebtedness

- (1) The term "average acquisition indebtedness" means the average amount of outstanding principal indebtedness for the portion of the taxable year during which the property is held by an organization. See Treas. Reg. 1.514(a)-1(a)(3)(i).
- (2) Compute average acquisition indebtedness by determining principal indebtedness on the first day in each calendar month during the taxable year,

adding them together, and then dividing the sum by the total number of months in the year during which the organization held the property. A fractional part of a month is treated as a full month in computing average acquisition indebtedness. See Treas. Reg. 1.514(a)-1(a)(3)(ii). To computing the percentage of any gain or loss to be taken into account on a sale or other disposition of debt-financed property, use the highest amount of the acquisition indebtedness with respect to such property during the 12-month period ending with the date of the sale or other disposition instead of the average acquisition indebtedness for the taxable year. See Treas. Reg. 1.514(a)-1(a)(1)(v).

- (3) In *Marprowear Profit-Sharing Trust v. Commissioner*, 74 T.C. 1086 (1980), a qualified trust under Section 401(a) negotiated a reduction in the purchase price of a shopping center, which was debt-financed property, two years after the trust purchased the property. Since this reduced the amount owing on the property, the trust argued that it should be allowed to retroactively reduce the acquisition indebtedness on the property back to the time of the purchase. The Tax Court disagreed. The Court noted that to hold otherwise would mean that a property's acquisition indebtedness could never be fixed because any mortgage payments, prepayments, or negotiated reductions of any sort in any subsequent taxable year would reduce the property's acquisition indebtedness.

## **H.2. Indeterminate Price**

- (1) In the event an organization purchases property in a transaction where neither the price nor debt is clearly stated, the unadjusted basis of property acquired (or improved) is the fair market value of the property (or improvement) on the date of acquisition (or completion of improvement). The initial acquisition indebtedness is the fair market value of the property (or improvement) on the date of acquisition (or completion of improvement) less any down payment or other initial payment applied to the principal indebtedness. See Treas. Reg. 1.514(a)-1(a)(4)(ii)-(iii) and the example in Treas. Reg. 1.514(a)-1(a)(4)(iv)
- (2) The average acquisition indebtedness of such property is computed in the usual manner as set forth in Treas. Reg. 1.514(a)-1(a)(3). See Treas. Reg. 1.514(a)-1(a)(4)(iii). The average adjusted basis of such property is computed as set forth in Treas. Reg. 1.514(a)-1(a)(2). See Treas. Reg. 1.514(a)-1(a)(4)(ii).

## **I. Special Rules Relating to Acquisition Indebtedness**

- (1) The following sections discuss the special rules relating to acquisition indebtedness.

### **I.1. Indebtedness Incurred in Performing Exempt Purpose**

- (1) Indebtedness incurred in performing exempt functions doesn't constitute "acquisition indebtedness." Therefore, "acquisition indebtedness" doesn't include the indebtedness incurred by an exempt credit union in accepting deposits from its members. See Treas. Reg. 1.514(c)-1(d).

- (2) In *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (N.D. Ala. 1986), the court held that purchasing securities on margin and with borrowed funds isn't inherent in the performance or exercise of a credit union's exempt purpose or function. Accordingly, the use of borrowed funds to purchase bonds and loans constituted acquisition indebtedness under Section 514(c) and any income derived therefrom would constitute unrelated debt-financed income under Section 514(a).
- (3) In *Southwest Texas Electrical Cooperative, Inc. v. Commissioner*, 67 F.3d 87 (5th Cir. 1995), affirming 1994-363 T.C.M. (1994), a nonprofit rural electric cooperative borrowed funds to replace its own funds it had spent in its exempt activities. Immediately after receiving the borrowed funds, it invested them in U.S. Treasury Notes. The Fifth Circuit held that the interest income from the Treasury Notes was unrelated debt-financed income.

## I.2. Change in Use of Property

- (1) If an organization converts property that is used in a manner described in Section 514(b)(1)(A), (B), (C), or (D) (excepted from debt-financed property) to a use that results in its treatment as debt-financed property, the outstanding principal debt on the property is thereafter treated as acquisition indebtedness. See Treas. Reg. 1.514(c)-1(a)(3).
- (2) **Example:** Four years ago, a university borrowed funds to acquire an apartment building as housing for married students. Last year, the university rented the apartment building to the public for nonexempt purposes. The outstanding principal debt becomes acquisition indebtedness as of the time the building was first rented to the public.

## I.3. Continued Debt

- (1) If an organization sells property and, without paying off debt that would be acquisition indebtedness if the property were debt-financed property, buys property that is otherwise debt-financed property, the unpaid debt is acquisition indebtedness for the new property. This is true even if the original property wasn't debt-financed property. See Treas. Reg. 1.514(c)-1(a)(4).
- (2) **Example:** To house its administration offices, an exempt organization bought a building using \$600,000 of its own funds and \$400,000 of borrowed funds secured by a pledge of its securities. The office building wasn't debt-financed property. The organization later sold the building for \$1 million without repaying the \$400,000 loan. It used the sale proceeds to buy an apartment building it rents to the general public. The unpaid debt of \$400,000 is acquisition indebtedness with respect to the apartment building. See Treas. Reg. 1.514(c)-1(a)(4).



## I.4. Property Acquired Subject to Mortgage or Lien

- (1) If property (other than certain gifts, bequests, and devises) is acquired subject to a mortgage, the outstanding principal debt secured by that mortgage is treated as acquisition indebtedness even if the organization didn't assume or agree to pay the debt. See Section 514(c)(2) and Treas. Reg. 1.514(c)-1(b)(1).
- (2) **Example:** An exempt organization paid \$50,000 for real property valued at \$150,000 and subject to a \$100,000 mortgage. The \$100,000 of outstanding principal debt is acquisition indebtedness, as though the organization had borrowed \$100,000 to buy the property. See Treas. Reg. 1.514(c)-1(b)(1).

## I.5. Liens Similar to a Mortgage

- (1) In determining acquisition indebtedness, a lien similar to a mortgage is treated as a mortgage. A lien is similar to a mortgage if title to property is encumbered by the lien for a creditor's benefit. However, when state law provides that a lien for taxes or assessments attaches to property before the taxes or assessments become due and payable, the lien isn't treated as a mortgage until after the taxes or assessments have become due and payable and the organization has had an opportunity to eliminate the lien by paying the amount it secured in accordance with state law. Pursuant to Treas. Reg. 1.514(c)-1(b)(2), liens similar to mortgages include (but aren't limited to):
  - a. Deeds of trust,
  - b. Conditional sales contracts,
  - c. Chattel mortgages,
  - d. Security interests under the Uniform Commercial Code,
  - e. Pledges,
  - f. Agreements to hold title in escrow, and
  - g. Liens for taxes or assessments (other than those discussed earlier in this paragraph).

## I.6. Exception for Property Acquired by Gift, Bequest, or Devise

- (1) If property subject to a mortgage is acquired by gift, bequest, or devise, the outstanding principal debt secured by the mortgage isn't treated as acquisition indebtedness during the 10-year period following the date the organization receives the property. See Section 514(c)(2)(B) and Treas. Reg. 1.514(c)-1(b)(3)(ii). However, this applies to a gift of property only if:
  - a. The mortgage was placed on the property more than 5 years before the date the organization received it, and
  - b. The donor held the property for more than 5 years before the date the organization received it.

- (2) This exception doesn't apply if an organization assumes and agrees to pay all, or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent. See Section 514(c)(2)(B).
- (3) Whether an organization has assumed and agreed to pay all or part of a debt in order to acquire the property is determined by the facts and circumstances of each situation. See Treas. Reg. 1.514(c)-1(b)(3).

## I.7. Modifying Existing Debt

- (1) Extending, renewing, or refinancing an existing debt is considered a continuation of that debt to the extent its outstanding principal doesn't increase. When the principal of the modified debt is more than the outstanding principal of the old debt, the excess is treated as a separate debt. See Section 514(c)(3).
- (2) Pursuant to Treas. Reg. 1.514(c)-1(c)(2), the following are examples of acts resulting in the extension or renewal of a debt:
  - a. Substituting liens to secure the debt,
  - b. Substituting obligees whether or not with the organization's consent,
  - c. Renewing, extending, or accelerating the payment terms of the debt, and
  - d. Adding, deleting, or substituting sureties or other primary or secondary obligors.
- (3) Debt increase. If the outstanding principal of a modified debt is more than that of the unmodified debt, and only part of the refinanced debt is acquisition indebtedness, the payments on the refinanced debt must be allocated pro rata between the old debt and the excess. See Treas. Reg. 1.514(c)-1(c)(3).
  - a. **Example.** An organization has an outstanding principal debt of \$500,000 that is treated as acquisition indebtedness. The organization borrows another \$100,000, which isn't acquisition indebtedness, from the same lender, resulting in a \$600,000 note for the total obligation. A payment of \$60,000 on the total obligation would reduce the acquisition indebtedness by \$50,000 ( $\$60,000 \times \$500,000 / \$600,000$ ) and the excess debt by \$10,000. See Treas. Reg. 1.514(c)-1(c)(3).

## I.8. Annuities

- (1) The term acquisition indebtedness doesn't include an obligation to pay an annuity which meets the following three requirements:
  - a. Is the sole consideration (other than a mortgage to which Section 514(c)(2)(B) applies) issued in exchange for property if, at the time of the exchange, the value of the annuity is less than 90 percent of the value of the property received in the exchange. See Section 514(c)(5)(A).



- b. Is payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time. See Section 514(c)(5)(B).
- c. Is payable under a contract which doesn't guarantee a minimum amount of payments or specify a maximum amount of payments and doesn't provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or other property. See Section 514(c)(5)(C).

## I.9. Certain Federal Financing

- (1) Under Section 514(c)(6)(A)(i), "acquisition indebtedness" doesn't include an obligation/debt to finance the purchase, rehabilitation, or construction of housing for low- and moderate-income persons to the extent that it is insured by the Federal Housing Administration.
  - a. **Example:** To the extent that an obligation is insured by the Federal Housing Administration under Section 221(d)(3) (12 U.S.C. 1715(l)(d)(3)) or Section 236 (12 U.S.C. 1715z-1) of Title II of the National Housing Act, as amended, the obligation isn't "acquisition indebtedness." See Treas. Reg. 1.514(c)-1(f).
- (2) Under Section 514(c)(6)(A)(ii), the term "acquisition indebtedness" doesn't include indebtedness incurred by a small business investment company licensed after the date of the enactment of the American Jobs Creation Act of 2004 under the Small Business Investment Act of 1958 if the indebtedness is evidenced by a debenture—
  - a. Issued by such company under section 303(a) of such Act, and
  - b. Held or guaranteed by the Small Business Administration.

## I.10. Lending of Securities

- (1) It is common practice for an owner of securities to lend the securities to a broker who uses them to make timely deliveries of securities to purchasers. In the usual transaction, the broker is required to return identical securities to the lender, and the loan of securities is fully collateralized by cash or marketable securities having a fair market value of not less than the fair market value of the securities loaned. The lender receives from the borrower amounts equal to the dividends paid on the stock during the period of the loan and additional compensation for the stock.
- (2) If an exempt organization enters into a securities loan (as defined in Section 512(a)(5)) as the owner/lender, there is no adverse consequence under Section 514. An obligation to return collateral isn't treated as acquisition indebtedness. All payments with respect to securities loans are deemed to be derived from the securities loaned and not from the collateral security or the investment of collateral security from such loans. Any deductions that are directly connected

with the collateral security for the loan or with the investment of the collateral security are deemed to be deductions directly connected with the securities loaned. See Section 514(c)(8).

- (3) By contrast, if an exempt organization incurs indebtedness to purchase securities that it loans to others, any income from such securities, including any income from the loan of the securities, would be treated as debt-financed income and would be subject to tax to the extent provided in Section 512(b)(4) and Section 514. See *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (N.D. Ala. 1986).
- (4) In *Kern County Electrical Pension Fund v. Commissioner*, 96 T.C. 845 (1991), the pension fund owned certificates of deposit at a savings and loan that could be withdrawn prior to maturity but only with a substantial reduction of the interest earned. At a time when interest rates were rising, the pension fund obtained a loan from the savings and loan using the certificates as collateral and invested the loan proceeds in new certificates at higher interest rates. The court rejected the pension fund's argument that the interest constituted "payments with respect to securities loans" under Section 512(a)(5). The pension fund didn't lend the old certificates to the savings and loan association but rather pledged the old certificates as collateral for a loan to itself. The court held that the interest received on the new certificates was income from debt-financed property and wasn't excludable from UBTI because it didn't represent, in substance, additional interest on the old certificates.

## **I.11. Acquisition Indebtedness of Certain Organizations**

- (1) Section 514(c)(9)(A) provides that, with certain exceptions, the term "acquisition indebtedness" doesn't include indebtedness incurred by a qualified organization in acquiring or improving any real property.
- (2) Pursuant to Section 514(c)(9)(C), a qualified organization includes:
  - a. A qualified trust under Section 401,
  - b. An educational organization described in Section 170(b)(1)(A)(ii) and its supporting organizations described in Section 509(a)(3),
  - c. A multiple-parent title holding company as described in Section 501(c)(25). A shareholder of a Section 501(c)(25) organization may be taxable on its pro rata share of income received from debt-financed property held by the Section 501(c)(25) organization if the shareholder itself isn't a "qualified organization," (see Section 514(c)(9)(F)) and
  - d. A retirement income account described in Section 403(b)(9).
- (3) Under Section 514(c)(9)(B), this exception doesn't apply if:
  - a. The price for the acquisition or improvement isn't a fixed amount determined as of the date of the acquisition or the completion of the improvement,

- b. The amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount is dependent, in whole or in part, upon any revenue, income or profits derived from the real property,
  - c. After the acquisition the real property is leased to the seller or to a person related to the seller as described in Section 267(b) or Section 707(b),
  - d. In the case of a qualified trust the real property is acquired from or leased to certain disqualified persons under Section 4975(e)(2),
  - e. Any person described in (c) or (d) provides the qualified organization with financing in connection with the acquisition or improvement, or
  - f. The real property is held by a partnership, unless the partnership meets the requirements of clauses (a) through (e) above , and unless (I) all of the partners of the partnership are qualified organizations, (II) each allocation to a partner of the partnership which is a qualifying organization is a qualified allocation under Section 168(h)(6) or, (III) the partnership meets the "disproportionate allocation rule of Section 514(c)(9)(E)."
- (4) In order for a partnership to meet the " disproportionate allocation rule," both of the following requirements must be met:
- a. The allocation of items to any partner which is a qualified organization can't result in such partner having a share of the overall partnership income for any taxable year greater than such partner's "fractions rule percentage" (in other words, such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest). See Section 514(c)(9)(E)(i)(I) and Treas. Reg. 1.514(c)-2(c)(2).
  - b. Each partnership allocation must have "substantial economic effect" within the meaning of Section 704(b)(2). See Section 514(c)(9)(E)(i)(II) and Treas. Reg. 1.514(c)-2(b)(1)(ii). Allocations that can't have economic effect must be deemed to be in accordance with the partners' interests in the partnership. See Treas. Reg. 1.514(c)-2(c)(4) for examples of how these rules operate.
- (5) Overall partnership income is the amount by which the aggregate items of partnership income and gain for the taxable year exceed the aggregate items of partnership loss and deduction for the year. Overall partnership loss is the amount by which the aggregate items of partnership loss and deduction for the taxable year exceed the aggregate items of partnership income and gain for the year. See Treas. Reg. 1.514(c)-2(c)(1).
- (6) Generally, the partnership items that are included in computing overall partnership income or loss are those items of income, gain, loss, and deduction that increase or decrease the partners' capital accounts. Treas. Reg. 1.514(c)-2(c)(1)(i).

- (7) Generally, a guaranteed payment to a qualified organization (QO) isn't treated as an item of partnership loss or deduction in computing overall partnership income or loss. See Treas. Reg. 1.514(c)-2(c)(1)(ii)(A) but also see Treas. Reg. 1.514(c)-2(d) (exclusion of reasonable preferred returns and guaranteed payments)."
- (8) A partnership typically doesn't qualify for the UBIT exception provided by Section 514(c)(9)(A) for any taxable year of its existence unless it satisfies the fractions rule for every year to which the fractions rule applies. A partnership must satisfy the fractions rule both on a prospective basis and on an actual basis for each partnership taxable year, beginning with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a qualified organization as a partner. Treas. Reg. 1.514(c)-2(b)(2)(i).
- (9) A subsequent change to a partnership agreement that causes the partnership to violate the fractions rule ordinarily causes the partnership's income to fail the UBIT exception provided by Section 514(c)(9)(A) only for the taxable year of the change and subsequent taxable years. See Treas. Reg. 1.514(c)-2(b)(2)(ii).
- (10) A qualified organization's fractions rule percentage is that partner's percentage share of overall partnership loss for the partnership taxable year for which that partner's percentage share of overall partnership loss will be the smallest. See Treas. Reg. 1.514(c)-2(c)(2).
- (11) Except to the extent provided in Treas. Reg. 1.514(c)-2(d), income that a qualified organization may receive or accrue with respect to a guaranteed payment is treated as an allocable share of overall partnership income or loss for purposes of the fractions rule. See Treas. Reg. 1.514(c)-2(c)(1)(ii)(B).
- (12) The IRS has issued proposed regulations (REG-136978-12) under Treas. Reg. 514(c)(9)(E) regarding the application of the fractions rule to partnerships that hold debt-financed real property and have one or more qualified tax-exempt organization partners. Issues relating to these proposed regulations should be coordinated with the appropriate Knowledge Management group.

## **J. Debt-Financed Property Exceptions**

- (1) There are several exceptions to the debt-financed property rules, including the following types of property.

### **J.1. Property Related to Certain Exempt Purposes**

- (1) Section 514(b)(1)(A) provides that if substantially all the use of any property is substantially related to the exercise or performance of an organization's exempt purpose, such property isn't treated as "debt-financed property." The term "substantially all" is defined as 85 percent or more. Treas. Reg. 1.514(b)-1(b)(1)(ii). See Treas. Reg. 1.513-1 for principles applicable in determining whether the particular use of property is substantially related to the exempt purpose of the organization. See Treas. Reg. 1.514(b)-1(b)(1)(i).

- (2) The extent a property is used for a particular purpose is determined based on all the facts and circumstances. Pursuant to Treas. Reg. 1.514(b)-1(b)(1)(ii), this determination may include, where appropriate:
  - a. A comparison of the portion of time such property is used for exempt purposes with the total time such property is used.
  - b. A comparison of the portion of such property that's used for exempt purposes with the portion of such property that is used for all purposes.
  - c. Both of these comparisons.
- (3) Rev. Rul. 77-47, 1977-1 C.B. 157 provides that buildings, acquired through assumption of outstanding mortgages by an exempt organization that restores, preserves, and exhibits buildings of historical and/or architectural significance, constitute debt-financed property when they are leased at fair rental value for uses that neither bear any relationship to the buildings' historical or architectural significance nor accommodate viewing by the general public.
- (4) An organization exempt under Section 501(c)(6) subjected a shell building it owned to a mortgage so it could finance its completion to suit the needs of its tenant. Notwithstanding that the organization had to borrow money and mortgage its property to finance the alterations, the building wasn't debt-financed under Section 514, because the organization was furthering its stated purpose of promoting the commercial development of its metropolitan area by encouraging new industries to move to the area. Therefore, the leasing activity was substantially related within the meaning of Section 514(b)(1)(A)(i) to the organization's accomplishment of its exempt purpose. See Rev. Rul. 81-138, 1981-1 C.B. 358.
- (5) In *Elliot Knitwear Profit Sharing Plan. v. Commissioner* 71 T.C. 65 (1979), aff'd, 614 F.2d 347 (3rd Cir, 1980), an employee profit-sharing plan that was exempt from tax under Section 501(a) because it qualified under Section 401(a) purchased securities on margin. The court held the securities purchased on margin (in other words, with funds borrowed from a broker) constituted debt-financed property and that the profits derived from their sale are taxable as unrelated business income since the purchase of securities on margin isn't inherent to the purpose of a tax-exempt profit-sharing plan and that such purchases aren't substantially related to the purpose of such an organization so as to be excepted from the definition of debt-financed property.
- (6) In *Alabama Central Credit Union v. United States*, 646 F. Supp. 1199 (N.D. Ala. 1986), the court considered whether income from securities purchased on margin or with borrowed funds was income from debt-financed property. There, a credit union exempt under Section 501(a) as an organization described in Section 501(c)(14) received income from the sale of Government of Israel bonds and construction loan certificates guaranteed by the Government National Mortgage Association. The court held the securities are debt-financed property, and that purchasing securities on margin and with borrowed funds

isn't inherent in the performance or exercise of a credit union's purpose or function.

- (7) If less than 85 percent of the use of any property is devoted to an organization's exempt purposes, only that portion of the property used in furtherance of the organization's exempt purposes isn't treated as debt-financed property. See Treas. Reg. 1.514(b)-1(b)(1).

a. **Example:** X, an exempt college, owns a four-story office building purchased with borrowed funds. In 20xx, the lower two stories of the building are used to house computers which are used by X for administrative purposes. The top two stories are rented to the public for purposes not described in Section 514(b)(1)(A), (B), (C), or (D). The gross income derived by X from the building is \$6,000, all attributable to the rents paid by tenants. There are \$2,000 of expenses, allocable equally to each use of the building. The average adjusted basis of the building for 20xx is \$100,000, and the outstanding principal indebtedness throughout 20xx is \$60,000. Thus, the average acquisition indebtedness for 20xx is \$60,000. Since the two lower stories are used for exempt purposes, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with such income are to be taken into account in computing unrelated business taxable income. The portion of such amounts to be taken into account is determined by multiplying the \$6,000 of rental income and \$1,000 of deductions directly connected with such rental income by the debt/basis percentage. The debt/basis percentage is the ratio which the allocable part of the average acquisition indebtedness is of the allocable part of the average adjusted basis of the property, that is, the ratio which \$30,000 (one-half of \$60,000) bears to \$50,000 (one-half of \$100,000). Thus, the debt/basis percentage for 20xx is 60 percent (the ratio of \$30,000 to \$50,000). Under these circumstances, X shall include net rental income of \$3,000 in its unrelated business taxable income for 20xx, computed as follows:

<b>X's Net Rental Income</b>	
Total Rental Income	\$6,000
Deductions directly connected with rental income	\$1,000
Debt/Basis Percentage (\$30,000/\$50,000)	60%
Rental income treated as gross income from unrelated trade or business (60% x \$6,000)	\$3,600
Less the allowable portion of deductions directly connected with such income (60% x \$1,000)	<u>- \$600</u>

Net rental income excluded by X in computing its unrelated business taxable income pursuant to Section 514	<u>\$3,000</u>
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## J.2. Property Used in Unrelated Trade or Business

- (1) Property, to the extent that the income from such property is taken into account in computing the gross income of any unrelated trade or business, isn't treated as "debt-financed property." See Section 514(b)(1)(B).
- (2) However, any gain on the disposition of such property which isn't included in income from an unrelated trade or business by reason of Section 512(b)(5) is includible as gross income derived from, or on account of, debt-financed property. See Treas. Reg. 1.514(b)-1(b)(2)(i).
- (3) Section 514 doesn't apply to amounts otherwise included in the computation of unrelated business taxable income, such as rents from personal property included under Section 512(b)(3), or rents and interest from controlled organizations includible under Section 512(b)(13). See Treas. Reg. 1.514(b)-1(b)(2)(ii).

## J.3. Property Related to Research Activities

- (1) Section 514(b)(1)(C) provides that property, to the extent it produces gross income derived from research activities otherwise excluded from the unrelated trade or business tax by Section 512(b)(7), (8), or (9), isn't treated as "debt-financed property." See Treas. Reg. 1.514(b)-1(b)(4).

## J.4. Property Producing Income Derived from an Activity Excepted from the Definition of Unrelated Trade or Business by Section 513(a)(1), (2), or (3)

- (1) Under Section 514(b)(1)(D), debt-financed property doesn't include any property to the extent it produces income from a trade or business excepted from the definition of an "unrelated trade or business" by Section 513(a)(1), (2), or (3). Thus, property used in connection with the donated merchandise, volunteer labor, or convenience exceptions doesn't constitute debt-financed property. See Treas. Reg. 1.514(b)-1(b)(5).

## J.5. Use By Related Organization

- (1) Property owned by an exempt organization and used by a related exempt organization or by an exempt organization related to such related exempt organization isn't treated as "debt-financed property" to the extent such property is used by either of such related exempt organizations in furtherance of their exempt purposes. Furthermore, property isn't treated as debt-financed property to the extent such property is used by a related exempt organization for a purpose described in Section 514(b)(1)(A), (C), or (D). See Section 514(b)(2) and Treas. Reg. 1.514(b)-1(c)(2)(i).



- a. **Example:** M, an exempt trade association described in Section 501(c)(6), leases 70 percent of the space of an office building for furtherance of its exempt purpose. The title to such building is held by N, an exempt title holding company described in Section 501(c)(2), which acquired title to the building with borrowed funds. The other 30 percent of the space of this office building is leased to L, a nonstock exempt trade association described in Section 501(c)(6). L uses such office space in furtherance of its exempt purpose. The members of L's Board of Trustees serve for fixed terms and M's Board of Directors has the power to select all such members. N pays over to M all the profits it derives from the leasing of space in this building to M and L. Accordingly, M is "related" to N and L is "related" to M. Under these circumstances, since all the available space in the building is leased to either an exempt organization related to the exempt organization holding title to the building or an exempt organization related to such related exempt organization, no portion of the building is treated as debt-financed property.
- (2) Under Section 514(b)(2), use of property by a "related exempt organization" is taken into account in determining the extent property is used for a purpose described in Section 514(b)(1)(A), (C), or (D).
- (3) Pursuant to Treas. Reg. 1.514(b)-1(c)(2)(ii), an exempt organization is related to another exempt organization only if:
  - a. One organization is an exempt title holding company described in Section 501(c)(2) and the other receives profits derived from such exempt title holding company,
  - b. One organization has control of the other within the meaning of Treas. Reg. 1.512(b)-1(l)(4),
  - c. More than 50 percent of the members of one organization are members of the other, or
  - d. Each organization is a local organization directly affiliated with a common state, national, or international organization which is also exempt.

## J.6. Medical Clinics

- (1) Real property isn't debt-financed property if it is leased to a medical clinic, and the lease is entered into primarily for purposes that are substantially related to the exempt purposes of the lessor. See Section 514(b)(1) and Treas. Reg. 1.514(b)-1(c)(1).
- (2) **Example:** Assume an exempt-hospital leases all of its clinic space to an unincorporated association of physicians and surgeons who, by the provisions of the lease, agree to provide all of the hospital's out-patient medical and surgical services and to train all of the hospital's residents and interns. In this situation, the rents received aren't unrelated debt-financed income.

## J.7. Life Income Contract

- (1) Under Treas. Reg. 1.514(b)-1(c)(3), a life income contract isn't treated as debt-financed property if the following circumstances are present:
  - a. An individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to him/her or other individuals or both for a period of time not to exceed the life of such individual or individuals in a transaction in which the payments to the individual or individuals don't constitute the proceeds of a sale or exchange of the property so transferred, and
  - b. The remainder interest is payable to an exempt organization described in Section 501(c)(3).
- (2) **Example:** On January 1, 1967, A transfers property to X, an exempt organization described in Section 501(c)(3), which immediately places the property in a fund. On January 1, 1971, A transfers additional property to X, which property is also placed in the fund. In exchange for each transfer, A receives income participation fund certificates which entitle him/her to a proportionate part of the fund's income for his/her life and for the life of another individual. None of the payments made by X is treated by the recipients as the proceeds of a sale or exchange of the property transferred. In this situation, none of the property received by X is treated as debt-financed property.

## K. Neighborhood Land Rules

- (1) If an organization acquires real property for the principal purpose of using the land in the performance of its exempt purpose (within 10 years), it won't be treated as debt-financed property if it is in the neighborhood of other property used by the organization for exempt purposes and the intent to use the property for exempt purposes (within 10 years) isn't abandoned. This provision is referred to as the "neighborhood land rule." See Section 514(b)(3)(A).
- (2) Property is considered in the "neighborhood" of property owned and used by an organization for its exempt purposes if the acquired property is contiguous with the exempt purpose property or would be contiguous but for a road, street, railroad, stream, or similar property. If the acquired property isn't contiguous with the exempt purpose property, it may still be in the "neighborhood" of such property if it is within one mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. See Treas. Reg. 1.514(b)-1(d)(1)(ii).
- (3) Some criteria to consider in determining whether noncontiguous property is still in the "neighborhood" of exempt purpose property include the availability of land and the intended future use of the land. For example, a university attempts to purchase land contiguous to its present campus but can't do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university

purchases such land. Under these circumstances, the contiguity requirement is unreasonable, and the land purchased would be considered "neighborhood land." See Treas. Reg. 1.514(b)-1(d)(1)(ii).

## K.1. Exceptions

- (1) The neighborhood land rule doesn't apply to property 10 years after it is purchased. Further, the rule applies after the first five years only if the organization satisfies the IRS that future use of the land for exempt purposes before the expiration of the 10-year period is reasonably certain. The organization doesn't need to show binding contracts in satisfying this requirement but must have a definite plan detailing a specific improvement and a completion date and show some affirmative action toward the fulfillment of such plan. At least 90 days prior to the end of the fifth year after acquisition of the land, the organization must forward the necessary information to the IRS for a letter ruling request under Rev. Proc. 2023-1 (updated annually), 2023-1 IRB 1. See Treas. Reg. 1.514(b)-1(d)(1)(iii).
- (2) If the neighborhood land rule is inapplicable because the acquired land isn't in the neighborhood of other land used for exempt purposes or because the organization fails to establish after the first five years that the property will be used for exempt purposes, but the land is eventually used for exempt purposes within the 10-year period, such property isn't treated as debt-financed property for any period prior to such conversion. See Section 514(b)(3)(B) and Treas. Reg. 1.514(b)-1(d)(2). Where the neighborhood land rule is initially inapplicable, but the land is eventually used for exempt purposes, a refund of taxes shall be allowed in accordance with Section 514(b)(3)(D) and Treas. Reg. 1.514(b)-1(d)(4).

## K.2. Limitations

- (1) The neighborhood land rule applies with respect to any structure on the land when acquired, or to the land occupied by the structure, only so long as the intended future use of the land requires that the structure be demolished or removed in order to use the land for exempt purposes. See Section 514(b)(3)(C)(i). Thus, during the first five years after acquisition (and for subsequent years if there is a favorable ruling in accordance with Section 514(b)(3), improved property isn't debt-financed so long as the organization doesn't abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. Treas. Reg. 1.514(b)-1(d)(3)(i) provides that if there is an actual demolition of such structures, the use made of the land need not be the one originally intended as long as it is any use which furthers the exempt purposes of the organization.
- (2) In addition to the above limitation, the neighborhood land rule and exceptions don't apply to either structures erected on the land after its acquisition or to property subject to a business lease (as defined in Section 514(f) immediately before the enactment of the Tax Reform Act of 1976) whether the organization

acquired the property subject to the lease or whether it executed the lease subsequent to acquisition. See Section 514(b)(3)(C)(ii) and (iii) and Treas. Reg. 1.514(b)-1(d)(3)(iii).

### **K.3. Churches**

- (1) The neighborhood land rule also applies to churches as well as conventions or associations of churches, but with two differences.
  - a. First, instead of the 10-year period during which an organization must demonstrate intent to use acquired property for exempt purposes, a 15-year period applies.
  - b. Second, there is no requirement that the acquired land be in the neighborhood of other property used by the organization for exempt purposes. See Section 514(b)(3)(E) and Treas. Reg. 1.514(b)-1(e).

## **VI. Modifications for Computing Unrelated Business Taxable Income**

- (1) Section 512(b) excludes certain items of income, and any deductions directly connected with them, from unrelated business taxable income. Whether a particular item of income falls within any of these modifications depends on the substantive nature of the item rather than its form so that all the facts and circumstances in each case must be fully considered. The following sections discuss such modifications.
- (2) Several Section 512(b) provisions also include in the computation of UBTI certain kinds of passive income (and associated deductions) that would otherwise be excluded under Section 512(b), including Section 512(b)(4) (which cross-references Section 514 unrelated debt-financed income, discussed in Part V of this document), Section 512(b)(13) (interest, annuities, royalties, and rents from controlled entities), and Section 512(b)(17) (certain amounts received from foreign corporations attributable to insurance income).

### **A. Dividends, Interest, and Annuities**

- (1) Under Section 512(b)(1), dividends, interest, and annuities, as well as the deductions directly connected with these types of income, are excluded in computing unrelated business taxable income. Section 512(b)(1) also excludes payments with respect to securities loans (separately discussed in Parts V.I.10 and VI.A.1 of this document), and consideration for agreeing to make a loan. However, if such income is derived from debt-financed property (Section 514, which largely excludes annuities under Section 514(c)(5)) or, in the case of interest and annuities is derived from a controlled organization (Section 512(b)(13)), it is included in computing unrelated business taxable income to the extent provided in those sections.
- (2) Treas. Reg. 1.512(b)-1(a)(1) expands the modification contained in Section 512(b)(1) to exclude income from notional principal contracts and directly

connected deductions. The regulation also excludes other substantially similar income from ordinary and routine investments to the extent determined by the IRS. See Treas. Reg. 1.512(b)-1(a)(2) and (3) for limitations and effective dates.

- (3) Rev. Rul. 79-349, 1979-2 C.B. 233, describes an exempt employees' trust engaged in the unrelated trade or business of making mortgage loans in a commercial manner. The ruling holds that the interest earned on the loans is excluded from the computation of the organization's unrelated business taxable income under Section 512(b)(1). The service fees charged on the loans such as for investigating the prospective borrower and his security, closing costs, and fees paid to a third party for servicing and collecting the loan are included.
- (4) Treas. Reg. 1.512(b)-1(a)(1) provides that an inclusion of subpart F income under Section 951(a)(1)(A), or an inclusion of global intangible low-taxed income under Section 951A(a), is treated as a dividend for purposes of Section 512(b)(1). However, Section 512(b)(17) requires any amount included in gross income under Section 951(a)(1)(A) to be included as an item of gross income from an unrelated trade or business to the extent that the amount is attributable to insurance income (as defined in Section 953) and would be treated as gross income from an unrelated traded or business if derived directly by the organization.

## **A.1. Income from Lending Securities**

- (1) Payments received by an exempt organization for loans of securities in its investment portfolio to brokers aren't treated as unrelated business income. See Sections 512(b)(1) and 512(a)(5). In order for the payments to qualify under Section 512(b)(1), however, the securities must be loaned pursuant to an agreement which:
  - a. Provides for the return to the exempt organization of identical securities loaned;
  - b. Requires that payments be made to the exempt organization in amounts equivalent to the interest, dividends, and other distributions that the owner of the securities is entitled to receive because of its ownership during the period of the loan;
  - c. Doesn't reduce the exempt organization's risk of loss or opportunity for gain as to the transferred securities;
  - d. Contains reasonable procedures to implement the obligation of the borrower to furnish collateral to the exempt organization with a fair market value on each business day the loan is outstanding in an amount at least equal to the fair market value of the securities at the close of business on the preceding day; and
  - e. Permits the exempt organization to terminate the loan at any time upon notice of no more than five business days. See Sections 512(b)(1) and

512(a)(5) (discussed in Part V.I.10 of this document). See also Section 1058 regarding nonrecognition of gain or loss on transfer of securities under certain agreements.

- (2) This treatment isn't available if the securities which are loaned constitute inventory or are being held for sale to customers in the ordinary course of the organization's trade or business. See Rev. Rul. 78-88, 1978-1 C.B. 163 (holding that income derived by an exempt organization from the temporary transfer of securities to a brokerage house isn't unrelated business income where the securities transferred were neither inventory nor held for sale to customers in the ordinary course of a trade or business)

## **A.2. Royalties**

- (1) Royalties, including overriding royalties, are excluded under Section 512(b)(2), whether measured by production or by gross or taxable income from the property. All deductions directly connected with excludable royalties must also be excluded. However, if royalty income is derived from debt-financed property (Section 514) or controlled organizations (Section 512(b)(13)), it is included in computing unrelated business income to the extent provided in those sections.
- (2) To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use of such property, are ordinarily classified as royalties for federal tax purposes. See *Commissioner v. Affiliated Enterprises, Inc.*, 123 F.2d 665 (10th Cir. 1941), cert. denied 315 U.S. 812 (1942).
- (3) Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties. See generally, *Cepeda v. Swift & Co.*, 415 F.2d 1205 (8th Cir. 1969) and Rev. Rul. 81-178, 1981-2 C.B. 135. Situation 1 of Rev. Rul. 81-178 relies on the rationale of the cases cited therein in reaching the conclusion that income from licensing agreements involving the use of certain athletes' names, photographs, etc. is royalty income and thus excludable under Section 512(b)(2).
- (4) Royalties don't include payments for personal services. Situation 2 of Rev. Rul. 81-178 presents an example in which, an exempt organization entered into a licensing agreement for the endorsement of certain products and services that require personal appearances by, and interviews with, members of the organization. Income from such agreements is gross income from unrelated trade or business and because the payments received by the organization are compensation for personal services, they aren't excluded as royalties under Section 512(b)(2).
- (5) In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), aff'g T.C. Memo. 1993-199, aff'g in part and rev'g in part and remanding 103 T.C. 307 (1994), the court confirmed that there is a distinction between payments for services and payments for the right to use an intangible property right. The court held that royalties under Section 512(b)(2) are defined as payments

received for the right to use intangible property rights, and that royalties don't include payments for services.

(6) Other derivations of this concept include:

- a. **Mailing Lists** — Based on the above definition, the Court of Appeals affirmed the decision of the Tax Court in *Sierra Club, Inc. v. Commissioner*, T.C. Memo. 1993-199 and found that income from mailing list rentals constituted royalty income the organization was described in Section 501(c)(4) and thus couldn't use the Section 513(h) exception discussed in Part VII.I of this document. The Court of Appeals concluded that Sierra Club received royalty income. In so concluding, the court noted that Sierra Club neither performed services relating to the mailing list rental nor marketed the mailing lists. Sierra Club merely collected a fee for the mailing list rental. The court, rejecting the argument that any active marketing activity would convert a royalty into a non-royalty, specifically noted that Sierra Club activity in connection with the rental of its mailing list was substantially less than the amount of activity which other courts had found to preclude a finding of royalty income. The Ninth Circuit's decision left unanswered the question of what services an exempt organization can perform in connection with mailing list rentals and still treat the income from them as royalty income. Although the court rejected the Tax Court's all-inclusive definition of royalties as including "active" and "passive" income, it didn't state what activities will cause an organization to have unrelated business taxable income. The Ninth Circuit's decision in *Sierra Club, Inc.* is inconsistent with the IRS's administrative position that income from the regular sale of membership mailing lists by an exempt organization is subject to the unrelated business income tax and isn't a royalty under Section 512(b)(2).
- b. *Disabled American Veterans v. United States*, 650 F.2d 1178, 227 Ct. Cl. 474 (1981), where the Court of Claims found that because the organization performed substantial business activity in preparing and mailing the lists, royalty treatment was precluded.
- c. **Affinity Credit Cards** — In *Sierra Club, Inc. v. Commissioner*, T.C. Memo. 1999-86, the Tax Court also held that the revenue from an affinity credit card program didn't constitute unrelated business income because it constituted income from royalties under Section 512(b)(2). See also, *Oregon State University Alumni Association, Inc. v. Commissioner*, T.C. Memo. 1996-34, *Alumni Association of the University of Oregon, Inc. v. Commissioner*, T.C. Memo. 1996-63, and *Mississippi State University Alumni, Inc. v. Commissioner*, T.C. Memo. 1997-397. The Tax Court concluded that revenues received as part of the affinity card program weren't received as compensation for services, but as payment for an intangible property right. Such compensation therefore constituted royalty income under Section 512(b)(2). Generally, The IRS's administrative approach in the area of mailing lists and affinity credit cards is that such



cases should be resolved in a manner consistent with existing court cases. In the cases decided in favor of the taxpayer, the facts showed that the involvement of the exempt organization was relatively minimal, and the organizations generally hired outside contractors to perform most services associated with exploitation of the use of intangible property. Thus, courts concluded that the payment was for the intangible property rather than for services of the organization's members or employees.

- d. In December 1999, the Director, Exempt Organizations Division, issued a memorandum on mailing lists and affinity credit cards advising that “it is now clear that courts will continue to find [income from mailing list rentals and affinity credit card arrangements] to be excluded royalty income unless the factual record clearly reflects more than insubstantial services being provided.” These cases should be resolved in a manner consistent with existing court cases.
- (7) The royalty exclusion doesn't apply to royalties which stem from an arrangement whereby the organization owns a working interest in a mineral property and is liable for its share of the development costs under the terms of its agreement with the operator of the property. See Treas. Reg. 1.512(b)-1(b). An exempt organization's income from a mineral interest isn't a royalty excluded from the computation of unrelated business taxable income by Section 512(b)(2), where the organization is liable for the operating expenses associated with its interest. Rev. Rul. 69-179, 1969-1 C.B. 158.
  - (8) Patent development and management service fees deducted from royalties collected from licensees by an exempt charitable organization for distribution to the beneficial owners of the patents aren't within the exception for royalties provided by Section 512(b)(2). The fees, although derived from royalties, constituted compensation for services provided by the organization. See Rev. Rul. 73-193, 1973-1 C.B. 262. However, Rev. Rul. 76-297, 1976-2 C.B. 178, provides that amounts received from licensees by an exempt organization, the legal and beneficial owner of patents assigned to it by inventors for specified percentages of future royalties, is royalty income that is excludable in computing unrelated business taxable income.
  - (9) In several cases involving income from advertising, exempt organizations have unsuccessfully sought to treat the income as royalties from the license of their publication to a contractor. The courts look to the substance of the transaction, not merely the parties' label on the agreement, and the contractor may be operating as the exempt organization's agent in conducting the advertising, on behalf of and under the control of the exempt organization.
    - a. In *Fraternal Order of Police Illinois State Troopers Lodge No. 41 v. Commissioner*, 87 T.C. 747 (1986), aff'd, 833 F.2d 717 (7th Cir. 1987), the court held, in part, that income from advertising appearing in an organization's magazine, *The Trooper*, was subject to tax on unrelated business income. The organization took an active role in publication of the

magazine and therefore its advertising income didn't constitute royalties under Section 512(b)(2).

- b. *NCAA v. Commissioner*, 92 T.C. 456 (1989), rev'd on other grounds, 914 F.2d 1417 (10th Cir. 1990), held that income received by NCAA for publishing commercial advertisements in its game programs for the basketball tournament was UBTI and not royalties. NCAA made a written agreement for a Publisher to produce and sell the programs, and to sell advertising to be placed in the programs. The Tax Court held that Publisher's activities should be attributed to NCAA as NCAA's agent, since the contract called for Publisher to perform services (1) on behalf of, and (2) under the control of, NCAA. Therefore, NCAA's advertising business was regularly carried on by it. The court noted that the contract designated Publisher as NCAA's "agent" (although contract designation isn't controlling); that the contract expressly called for Publisher to "provide services" to NCAA "in an efficient and workmanlike manner"; and that the contract contemplated that Publisher would "represent" NCAA in soliciting advertising. The court also noted that NCAA could control Publisher's activities, particularly by reserving the right to approve all advertising (the court accorded little weight to the fact that NCAA devoted little time to actual oversight). The court found an agency relationship existed despite the compensation structure (which shifted the risk of loss to Publisher) and the indemnification clause in favor of NCAA. Regarding the royalty issue, the court noted that licensors may reserve quality control rights (see Rev. Rul. 81-178, 1981-2 C.B. 135), but that the contract at issue wasn't a mere license to Publisher to use a valuable right of NCAA; it rather set forth an agency relationship, imposing a duty on Publisher to perform services on NCAA's behalf and under its control.
- c. *Arkansas State Police Ass'n v. Commissioner*, TCM 2001-38, involved an EO that entered into a "Royalties and Licensing Agreement" with a publisher to publish EO's official magazine containing articles and advertising. Publisher solicited the ads in EO's name. EO approved the sales pitches, ads, and editorial content. Publisher bore all production costs, paid EO an annual fee, and received 73 percent of the proceeds. The court rejected EO's royalty argument, reasoning that EO substantially participated in and maintained control over significant aspects of the publication. The court distinguished the mailing list and affinity credit card cases as involving minimal activity on the EO's part.

## **B. Exclusion of Rents from Unrelated Business Taxable Income**

- (1) Rents from real property generally are excluded in computing unrelated business taxable income. Some rents from personal property are also excluded. Special rules apply when rents are received from personal property leased with real property (mixed lease). See Section 512(b)(3).

- (2) Under law in effect prior to the Tax Reform Act of 1969, Section 512(b)(3) excluded all rents from real property (including personal property leased with the real property) and all deductions directly connected therewith in computing unrelated business taxable income. The intention was to exclude passive income from tax and not exclude an active business. However, exempt organizations began leasing business assets of an operating business to an independent management company and claiming the rent exclusion. The exempt organizations received most of the profits from the business in the form of "passive" rents and in one case the Tax Court held that such rental activity came under the rental exclusion for real property and personal property leased with real property. See *University Hill Foundation v. Commissioner*, 51 T.C. 548 (1969), rev'd, 446 F.2d 701 (9th Cir. 1971), cert. denied, 405 U.S. 965 (1972). If the exempt organization had conducted the business itself, the profits from the business would be unrelated business taxable income. Although *University Hill Foundation* was reversed on appeal, Section 512(b)(3) was amended to correct this abuse.
- (3) Consistent with the passive income concept, the Tax Reform Act of 1969 provided for the taxation of rent derived from the leasing of either real or personal property where the determination of the amount of such rent depends on the net income from the property. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 69 (1969), 1969-3 C.B. 468, 1969 U.S.C.C.A.N. 2027, 2091 and Treas. Reg. 1.512(b)-1(c)(2)(iii)(b).
- (4) If rents are derived from debt-financed property (Section 514) or controlled organizations (Section 512(b)(13)), they are included in computing unrelated business taxable income.

## **B.1. Real Property, Personal Property, and Property Placed in Service**

- (1) Real property is all real property including any property described in Section 1245(a)(3)(C) and Section 1250(c). See Section 512(b)(3)(A)(i) and Treas. Reg. 1.512(b)-1(c)(3)(i). Also, income derived from a lease of a pipeline system, consisting of right-of-way interests in land, pipelines buried in the ground, pumping stations, plants, equipment, and other appurtenant property, constitutes rent from real property. See Rev. Rul. 67-218, 1967-2 C.B. 213. An appurtenance, which can be defined as being immovable or fixed to the land, is real property.
- (2) Personal property is all personal property including any property described in Section 1245(a)(3)(B). See Treas. Reg. 1.512(b)-1(c)(3)(ii). Also, income derived from railroad cars leased to an industrial company that had the responsibility for operation and maintenance of the cars constitutes rent from personal property. See Rev. Rul. 60-206, 1960-1 C.B. 201. Also, see *Cooper Tire & Rubber Company Employees' Retirement Fund v. Commissioner*, 36 T.C. 96 (1961), aff'd, 306 F.2d 20 (6th Cir. 1962).
- (3) Property is placed in service when it is first subject to use by the lessee under the terms of the lease. For example, property subject to a lease entered into on

November 1, 1971, for a term commencing on January 1, 1972, shall be considered as placed in service on January 1, 1972, regardless of when the property is first actually used by the lessee. See Treas. Reg. 1.512(b)-1(c)(3)(iv).

## B.2. Mixed Leases

- (1) Rents from personal property leased with real property (mixed lease) are excluded where the rent from the personal property is an incidental amount of the total rent as determined at the time the personal property is first placed in service. See Section 512(b)(3)(A)(ii).
- (2) Rent from personal property will generally be considered incidental if the rent attributable to it doesn't exceed 10 percent of the total rents from all the leased property. See Treas. Reg. 1.512(b)-1(c)(2)(ii).
  - a. **Example 1:** If the rents attributable to the personal property leased are determined to be \$3,000 per year, and the total rents from all property leased are \$10,000 per year, then the \$3,000 isn't to be excluded from the computation of unrelated business taxable income, since such amount isn't an incidental portion of the total rents. Deductions directly connected with excluded rents aren't allowable.
- (3) Where the rent attributable to the personal property is more than 10 percent but doesn't exceed 50 percent of the total rent, determined at the time the personal property is first placed in service by the lessee, the rental income attributable to the real property is excluded from the computation of unrelated business taxable income. See Section 512(b)(3)(B)(i) and Treas. Reg. 1.512(b)-1(c)(2)(iii)(a).
- (4) Where the rent attributable to the personal property is more than 50 percent of the total rent, determined at the time the personal property is first placed in service by the lessee, none of the rent (including the rent from real property) is excluded.
- (5) Separate leases for real and personal property which have an integrated use (one or more leases for real property and another lease or leases for personal property to be used upon such real property) will be considered as one lease. See Treas. Reg. 1.512(b)-1(c)(3)(iii).
  - a. **Example 2:** On January 1, 1971, A, an exempt organization, executes two leases with B. One is for the rental of a computer, with a stated annual rental of \$750. The other is for the rental of office space in which to use the computer, at a stated annual rental of \$7,250. The total annual rent under both leases for 1971 is \$8,000. At the time the computer is first placed in service, however, taking both leases into consideration, it is determined that notwithstanding the terms of the leases, \$3,000, or 37.5 percent ( $\$3,000/\$8,000$ ), of the rent is actually attributable to the computer. Therefore, for 1971, only the \$5,000 ( $\$8,000$  less  $\$3,000$ ) attributable to the rental of the office space is excluded from the

computation of A's unrelated business taxable income. See Treas. Reg. 1.512(b)-1(c)(4) Example (1).

- (6) If a change in the amount of personal property in service results in an increase of 100 percent or more in the rent attributable to all the personal property leased, or there is a modification of the lease by which there is a change in the rent charged (whether or not there is a change in the amount of personal property rented), the rent attributable to personal property will be recomputed to determine whether the above mentioned 10 percent exclusion or 50 percent exception applies. Any change in the treatment of rents resulting from such recomputation is effective only for the period beginning with the event which occasioned the recomputation. See Treas. Reg. 1.512(b)-1(c)(3)(v). The following examples illustrate this principle.
- a. **Example 3:** Assume the facts as stated in example 2 set forth above in (5)a, except that on January 1, 1973, B rents a second computer from A, which is placed in service on that date. The total rent is increased to \$2,000 for the computer lease and to \$10,000 for the office space lease. It is determined at the time the second computer is first placed in service that notwithstanding the terms of the leases \$7,000 of the rent is actually attributable to the computers. Since the rent attributable to personal property has increased by more than 100 percent ( $\$4,000/\$3,000$  equals 133 percent), a redetermination must be made. As a result, 58.3 percent ( $\$7,000/\$12,000$ ) of the total rent is determined to be attributable to personal property. Accordingly, since more than 50 percent of the total rent A receives is attributable to the personal property leased, none of the rents is excluded from the computation of A's unrelated business taxable income by operation of Section 512(b)(3).
- b. **Example 4:** Assume the facts as example 3 above, except that on June 30, 1975, the lease between B and A is modified. The total rent for the computer lease is reduced to \$1,500 and the total rent for the office space lease is reduced to \$7,500. Pursuant to this lease modification by which there is a change in the rent charged a redetermination is made as of June 30, 1975. As of the modification date, it is determined that notwithstanding the terms of the leases, the rent actually attributable to the computers is \$4,000 or 44.4 percent ( $\$4,000/\$9,000$ ), of the total rent. Since less than 50 percent of the total rent is now attributable to personal property, the rent attributable to real property (\$5,000), for periods after June 30, 1975, is excluded from the computation of A's unrelated business taxable income by operation of Section 512(b)(3). However, the rent attributable to personal property, \$4,000, isn't excluded from unrelated business taxable income for such periods by operation of Section 512(b)(3) since it represents more than an incidental portion of the total rents.

### B.3. Income Based on Net Profits

- (1) Where the real or personal property rentals are measured in whole or in part on the income or profits derived by any person from the property leased, the total rent from real and personal property is taxed. However, a lease based on a fixed percentage of the gross receipts or sales won't be taxed solely by reason of such lease. See Section 512(b)(3)(B)(ii) and Treas. Reg. 1.512(b)-1(c)(2)(iii)(b).
- (2) In *Ohio County & Independent Agriculture Societies, Delaware County Fair v. Commissioner*, T.C. Memo. 1982-210, an agricultural society described in Section 501(c)(3) conducted an annual fair and also rented its fairgrounds to a horse sales company. Under a lease agreement, the exempt organization was paid 10 percent of the first \$10,000 of the lessee organization's yearly net profits from sales conducted on the premises, 20 percent of the next \$10,000, and 25 percent of all net profits in excess of \$20,000. The court held that the rents are based on a percentage of the lessee's net profits and, therefore, in accordance with Section 512(b)(3)(B)(ii), aren't excluded in computing the tax on unrelated business income.

### B.4. Rendering of Personal Services

- (1) Payment for the use or occupancy of rooms or other space where services are also rendered to the occupant doesn't constitute rent from real property. Therefore, the exclusion doesn't include transactions such as the use of hotel rooms, boarding house rooms or apartments furnishing hotel services. Other examples of uses involving services include tourist camps or homes, motels, use of space in parking lots, warehouses, or storage garages. See Treas. Reg. 1.512(b)-1(c)(5).
- (2) Generally, services are considered rendered to the occupant if they are primarily for his/her convenience and are different from those usually or customarily rendered in connection with the rental of rooms or space for occupancy only.
  - a. The supplying of maid service constitutes one example of a service rendered to the occupant primarily for his/her convenience and not usually or customarily rendered in connection with the rental of rooms or space for occupancy only. See Treas. Reg. 1.512(b)-1(c)(5). Furnishing of meals is another. See Rev. Rul. 69-69, 1969-1 C.B. 159.
  - b. The furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, and the collection of trash aren't considered as services rendered to the occupant. See Treas. Reg. 1.512(b)-1(c)(5). Also, security services, parking, an unstaffed exercise room, swimming pools, tennis courts and other recreational facilities, depending on the facts and circumstances, may be considered, as services customarily rendered in connection with the rental of rooms or space for occupancy only. See PLR 200241050 which addresses maintenance services, including security

guard services, not considered rendered to the occupant, Rev. Rul. 80-297, 1980-2 C.B. 196, Rev. Rul. 2004-24, 2004-1 C.B. 550 and *Madden v. Comm'r*, T.C. Memo. 1997-395. Note: PLRs cannot be cited as precedent but do offer an analysis of tax law used in certain circumstances.

- (3) Further examples applying the modification in Section 512(b)(3), excluding rents from real property from unrelated business income include:
  - a. Income derived by an exempt organization from the occasional use by outside individuals and groups of its meeting hall for a fee, where only utilities and janitorial services are provided, does constitute rent from real property within the meaning of Section 512(b)(3). See Rev. Rul. 69-178, 1969-1 C.B. 158.
  - b. Rev. Rul. 80-297, 1980-2 C.B. 196, considers two situations, both of which describe an exempt school that furnished the use of its tennis facilities for ten weeks during the summer. In the first situation, for ten weeks during the summer the school operates a tennis club. For a fee, the general public is invited to join the club and thereby use the school's tennis courts and dressing rooms during designated periods. The employees collected fees, scheduled courts, and administered club affairs. The revenue ruling holds that income to the school from this activity isn't excludable as rent from real property under Section 512(b)(3) because of the substantial services provided by the school. In the second situation, the school rented its tennis courts to an unrelated individual at a fixed fee which didn't depend, in whole or in part, on the income or profits derived from the leased property. The individual formed a tennis club and hired employees to operate the club. Since the school provided only the facilities and no services, the revenue ruling holds that the school's income under these circumstances is excludable rental income under Section 512(b)(3).
  - c. Rev. Rul. 80-298, 1980-2 C.B. 197, holds that a university's leasing of its stadium to a professional football team and provision of utilities, grounds maintenance, and dressing room, linen, and stadium security services is an unrelated trade or business under Section 513, and that income from this activity isn't excludable as rent from real property under Section 512(b)(3). Linen services, extensive ground maintenance, and stadium security provided by the university pursuant to a lease is furnishing substantial services for the convenience of the lessee that go beyond those usually rendered in connection with the rental of space for occupancy only and preclude the income from being classified as rent under Section 512(b)(3).

## **C. Gains and Losses from the Sale, Etc., of Property**

- (1) Section 512(b)(5) provides an exclusion from the computation of unrelated business taxable income for gains and losses from the sale, exchange, or other disposition of property which isn't:



- a. Stock in trade or other property of a kind which would properly be includable 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. In *Parklane Residential School, Inc. v. Commissioner*, T.C. Memo. 1983-139, a Section 501(c)(3) educational organization entered into 22 transactions over a two-year period involving the simultaneous purchase and sale of real property. The court held that these transactions constitute a regularly carried on trade or business that wasn't substantially related to the organization's exempt purpose or function. Amounts derived from these transactions were subject to tax on unrelated business income.
- (2) In addition, if an organization has made an election under Section 631 to treat the cutting of timber as a sale or exchange, any gains or losses resulting from such treatment shall not be excluded by reason of Section 512(b)(5).
  - (3) If a gain or loss is derived from the sale or other disposition of debt-financed property (Section 514), it is included in computing unrelated business income to the extent provided in that Section. See Treas. Reg. 1.512(b)-1(d)(1).and Part V.D. of this document.

### **C.1. Option Lapse Income**

- (1) The term "unrelated business taxable income" doesn't include gains realized on the lapse or termination of options to buy or sell securities when the options have been written in connection with the exempt organization's investment activities. See Section 512(b)(5). This applies whether or not the option is covered (in other words, whether or not the exempt organization owns the securities). Thus, all premiums received by an exempt organization on an option which it writes under these circumstances, regardless of whether the option lapses or is terminated, aren't unrelated business taxable income. See Treas. Reg. 1.512(b)-1(d)(2).
- (2) This treatment doesn't apply if an exempt organization writing the options takes such an active role in such activity that its options can be regarded an inventory or as being held for sale to customers in the ordinary course of its trade or business, or if the underlying securities on which the options are written constitute inventory or are being held for sale. See Treas. Reg. 1.512(b)-1(d)(2).
- (3) Similarly, if an organization is engaged in the trade or business of writing options, the exclusion won't be available.

### **D. Income from Research**

- (1) One of the exempt purposes listed in Section 501(c)(3) is scientific. Income from research that is substantially related to an organization's exempt scientific purposes doesn't constitute unrelated business taxable income.

- a. The term "scientific" includes the carrying on of scientific research in the public interest.
  - b. The term "research" has a variety of meanings and isn't synonymous with "scientific." The nature of particular research depends upon the purpose which it serves. For research to be scientific within the meaning of Section 501(c)(3), it must be carried on in furtherance of a scientific purpose. The determination of whether research is scientific doesn't depend on whether such research is classified as "fundamental" or "basic," in contrast to "applied" or "practical." See Treas. Reg. 1.501(c)(3)-1(d)(5) and TG 3-4 Exempt Purpose, Scientific Organizations 501(c)(3).
- (2) If an organization's research activities don't meet the requirements for scientific research under Treas. Reg. 1.501(c)(3)-1(d)(5), amounts derived from such research might still be excluded from unrelated business taxable income, if the provisions of Section 512(b)(7), (8), or (9) are applicable.
  - (3) Section 512(b)(7) excludes from unrelated business taxable income all income derived from research performed for the United States, or any of its agencies or instrumentalities, or any State or political subdivision thereof. All deductions directly connected with such research are also excluded. Under this provision, an exempt organization that conducts research for the government won't be subject to the tax on unrelated business income regardless of whether the research activities further an exempt purpose. The key consideration with respect to this modification is that the research is being performed for a government entity.
  - (4) Section 512(b)(8) excludes from unrelated business taxable income all income derived from research performed "for any person" by a college, university, or hospital. All deductions directly connected with such research are also excluded. Under this provision, income from research conducted by a college, university, or hospital won't be subject to tax on unrelated business income, regardless of whether the research activities further an exempt purpose of such organization. The key consideration with respect to this modification is that a college, university, or hospital is performing the research.
  - (5) Section 512(b)(9) excludes from unrelated business taxable income all income derived from research performed "for any person" by an organization operated primarily for the purpose of carrying on fundamental research. Such research may be performed "for any person," but the results of such research must be freely available to the general public. See Rev. Rul. 76-296, 1976-2 C.B. 142. The key considerations with respect to this modification are that the nature of the research is "fundamental" rather than "applied" and that the results are freely available to the general public.
    - a. The term "fundamental research" doesn't include research carried on for the primary purpose of commercial or industrial application. See Treas. Reg. 1.512(b)-1(f)(4). Whether an organization is operated primarily for the purpose of carrying on fundamental, as opposed to applied, research

is a question of fact to be determined based on all the facts and circumstances.

- b. Rev. Rul. 76-296, 1976-2 C.B. 141, holds that research isn't in the public interest and constitutes unrelated business if publication is withheld or delayed significantly beyond the time reasonably necessary to establish ownership rights. But research may constitute scientific research in the public interest even if commercially sponsored by private industries that will own any patents arising from the research if the results, including all relevant information, are timely published in such form as to be available to the interested public (delayed pending reasonable opportunity to establish the sponsor's patent ownership rights).
- (6) The term "research" doesn't include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment or buildings. Therefore, any income from such sources would constitute unrelated business income to an organization subject to tax under Section 511, if regularly carried on and not related to its exempt purposes. See Treas. Reg. 1.512(b)-1(f)(4).
- (7) In *Midwest Research Institute v. United States*, 554 F. Supp. 1379 (W.D. Mo. 1983) aff'd, 744 F.2d 635 (8<sup>th</sup> Cir. 1984), a Section 501(c)(3) scientific organization conducted research projects for independent sponsors on a contract basis. The lower court held that income from such research wasn't subject to tax on unrelated business income because the research business was substantially related to the accomplishment of scientific purposes (and thus didn't need to meet a Section 512(b) exception). The court stated that the application of scientific research results through private intermediaries produced public benefit which outweighed private benefit, that most of the income received was from scientific research, and that the research encouraged the development of industry within a particular area. Income received from marketing results of research and rental of computer time was unrelated business taxable income.
- (8) In *IIT Research Institute v. United States*, 9 Cl. Ct. 13 (1985), a Section 501(c)(3) scientific organization carried on numerous research assignments of various types pursuant to contracts. The organization generally priced its research services to cover its direct costs, overhead costs, and a profit of six percent. Of 650 contracts, 58 were selected as being representative of the organization's research endeavors. Of the 58 representative contracts, 34 were conceded to be substantially related. The remaining 24 were the subject of the court opinion. The Claims Court found that the research contracts were substantially related to scientific purposes because they either:
  - a. Involved the use of observation or experimentation to formulate or verify facts or natural laws,

- b. Could only have been performed by an individual possessing scientific or technical expertise,
  - c. Added to knowledge within a particular scientific field,
  - d. Involved the application of scientific or mathematical reasoning, or
  - e. Were attempts to systematize or classify a body of scientific knowledge by collecting information and presenting it in a useful form.
- (9) The court held that the research activities weren't commercial in nature, and that research results need not be published in every instance in order to serve a public purpose. See Treas. Reg. 1.501(c)(3)-1(d)(5)(iii). The court concluded by noting that in any event, income from nine of the 24 challenged contracts was excluded from unrelated business taxable income by Section 512(b)(7). The organization performed research for the United States or a political subdivision of a state in these nine contracts.

## **E. Charitable Contributions Deductions**

- (1) Under Section 512(b)(10), an organization described in Section 511(a)(2) (an organization other than a trust) is allowed a Section 170 deduction for charitable contributions up to 10 percent of its unrelated business taxable income (computed without regard to the Section 170 deduction for contributions). The deduction is allowed whether or not the contributions are directly connected with the carrying on of the trade or business. The provisions of Section 170(b)(2) aren't applicable to contributions by organizations described in Section 511(a)(2). See Treas. Reg. 1.512(b)-1(g)(1).
- (2) Under Section 512(b)(11), a trust described in Section 511(b)(2) is allowed a deduction for charitable contributions within the limitations prescribed by Section 170(b)(1)(A) and (B). However, the limitation on the deduction is determined by reference to unrelated business taxable income computed without regard to the deduction, rather than by reference to adjusted gross income. The deduction is allowed whether or not the contributions are directly connected with the unrelated business. For the purposes of this deduction, a distribution by the trust made pursuant to the trust instrument to a beneficiary described in Section 170 is treated in the same manner as a contribution. See Treas. Reg. 1.512(b)-1(g)(2).
- (3) Contributions, in order to be deductible, must be paid to another organization that qualifies under Section 170(c). For example, an exempt university that operates an unrelated business may deduct a contribution made to another university but may not claim a deduction for contributions with respect to amounts spent for administering its own educational program. See Treas. Reg. 1.512(b)-1(g)(3).
- (4) The term "unrelated business taxable income" as used in Section 512(b)(10) and (11) refers to unrelated business taxable income after application of

Section 512(a)(6) (UBIT siloing) for taxable years beginning on or after December 2, 2020. See Treas. Reg. 1.512(b)-1(g)(4), (5).

- (5) In *Crosby Valve & Gage Company v. Commissioner*, 380 F.2d 146 (1st Cir. 1967), cert. denied, 389 U.S. 976 (1967), the court considered whether a business corporation, wholly owned by a charitable foundation, was entitled to claim a deduction for property transferred to its parent without consideration. The court concluded that the transfer of property from subsidiary to parent wasn't a gift that was deductible under Section 170. Citing Section 512(b)(10), the court stated that a charitable organization is barred from making contributions to itself, and there is no reason for a difference in tax treatment merely because the income was earned by a wholly owned subsidiary, rather than directly by the tax-exempt organization.
- (6) In *South End Italian Independent Club, Inc. v. Commissioner*, 87 T.C. 168 (1986), acq. in result, 1987-2 C.B. 1 (IRS AOD-1987-15 (June 15, 1987)), the court held that a Section 501(c)(7) social club that distributed to charities its net proceeds from the operation of beano games in accordance with state law wasn't subject to the limitations imposed by Section 512(b)(10), since the distributions were deductible as ordinary and necessary business expenses under Section 162, rather than as charitable contributions under Section 170. The distribution of the proceeds for charitable purposes was a condition of the state license to operate such games. However, the transfer of bingo proceeds to an organization's general fund is no more deductible than a contribution to a reserve for future liabilities. See *Women of the Motion Picture Industry v. Commissioner*, T.C. Memo. 1997-518.

## **F. Specific Deduction**

- (1) Section 512(b)(12) provides for a \$1,000 deduction from gross income in computing unrelated business taxable income, except for purposes of computing the net operating loss under Section 172. The deduction is limited to \$1,000 regardless of the number of unrelated businesses in which the organization is engaged. See Rev. Rul. 68-536, 1968-2 C.B. 244.
- (2) An exception is provided in the case of a diocese, province of a religious order, or a convention or association of churches which may claim for each parish, individual church, district, or other local unit, a specific deduction limited to the lower of \$1,000 or the gross income derived from an unrelated trade or business regularly carried on by such local unit. If a local unit files its own Form 990-T, it claims the specific deduction limited to the lower of \$1,000 or the gross income derived from the unrelated trade or business. In such case, the diocese, province of a religious order, or convention or association of churches may not also claim that deduction. See Treas. Reg. 1.512(b)-1(h)(2)(i).

## **G. Income from Controlled Organizations**

- (1) Before 1969, rent, interest, royalty and annuity expenses were deductible in computing the income of a business, and receipt of such income by tax-exempt

organizations was generally excluded from unrelated business taxable income. Some exempt organizations would, therefore, "rent" their physical plant to a wholly owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enabled the taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 73 (1969), 1969-3 C.B. 471.

- (2) The Internal Revenue Service challenged but had not always been successful in its attempt to treat such rents as unrelated business taxable income and to characterize the payments according to the substance of the transaction.
  - a. In one case, an exempt foundation transferred its working interests in oil and gas properties to two corporations of which it was the controlling shareholder under agreements giving it "net profits overriding royalties" and requiring the company to look only to the income from production for reimbursement of expenses. The District Court held that the foundation wasn't engaged in a trade or business and that the contracts under which the foundation received income were in the form of overriding royalties. The Court of Appeals stated the district court determined that the contracts "...did in truth and in fact create income from overriding royalties and not income from working interests." It rejected the Government's argument that the contracts, though framed as to create an appearance of overriding royalties, were in substance working interests. The Court stated, "To agree with these views would call for a departure from the concepts of the terms, 'overriding royalties' and 'working interests.'" The court concluded that the amounts involved were royalties. See *Robert A. Welch Foundation v. United States*, 228 F. Supp. 881 (D.C. Tex. 1963), *aff'd* 334 F.2d 774 (5th Cir. 1964).
  - b. In Rev. Rul. 69-162, 1969-1 C.B. 158, the IRS announced that it wouldn't follow the decision in *Robert A. Welch Foundation* (above) but would continue to review exempt organizations' transfers of mineral properties to controlled corporations.
- (3) In Section 512(b)(13), special rules for certain amounts received from controlled entities, were added by the Tax Reform Act of 1969. This addition was part of an ongoing attempt to deal with the recharacterization issue.
- (4) In *J. E. and L. E. Mabee Foundation v. United States*, 533 F.2d 521 (10th Cir. 1976), a taxable corporation engaged in the production and sale of oil and gas through ownership of oil and gas leases. The corporation was a wholly owned subsidiary of a tax-exempt foundation, which received payments directly from oil purchasers rather than indirectly through its subsidiary. The foundation argued that the provisions of Section 512(b)(13) shouldn't be applicable because the income wasn't "derived from" the subsidiary. The court rejected this argument and held that Congress intended to tax a charitable organization's receipt of "royalties" from a controlled organization. In the court's

view, taxation doesn't depend upon the mechanical formality of whether the overriding royalty income was paid through the controlled organization generating the income, or directly to the charitable recipient.

- (5) Under Section 512(b)(13), the exclusions of interest, annuities, royalties, and rents provided by Section 512(b)(1), (2), and (3) don't apply where those amounts are derived from controlled organizations.
- (6) Section 512(b)(13) provides that, if an organization (referred to as the "controlling organization") receives or accrues (directly or indirectly) a "specified payment" from another entity which it controls (referred to as the "controlled entity"), the controlling organization must include the payment as an item of gross income derived from an unrelated trade or business to the extent the payment reduces the net unrelated income of the controlled entity (or increases any net unrelated loss of the controlled entity) notwithstanding Section 512(b)(1)-(3).
  - a. All deductions of the controlling organization directly connected with amounts treated as derived from an unrelated trade or business under the preceding sentence are allowed.
  - b. For purposes of Section 512(b)(13), the term "net unrelated income" means, in the case of a controlled entity which isn't exempt from tax under Section 501(a), the portion of the entity's taxable income which would be unrelated business taxable income if the entity were exempt from tax under Section 501(a) and had the same exempt purposes as the controlling organization, or in the case of a controlled entity which is exempt from tax under Section 501(a), the amount of the unrelated business taxable income of the controlled entity.
  - c. For purposes of Section 512(b)(13), the term "specified payment" means any interest, annuity, royalty, or rent.
  - d. For purposes of Section 512(b)(13), the term "control" means, in the case of a corporation, ownership (by vote or value) of more than 50 percent of the stock in such corporation; (in the case of a nonstock organization, Treas. Reg. 1.512(b)-1(l)(4)(i)(b) measures control not by the controlling organization's percentage of ownership but its percentage of control over the directors and trustees) in the case of a partnership, ownership of more than 50 percent of the profits interests or capital interests in such partnership, or in any other case, ownership of more than 50 percent of the beneficial interests in the entity.
  - e. Under Section 512(b)(13)(D)(ii), the constructive ownership rules of Section 318 (relating to constructive ownership of stock) apply for purposes of determining ownership of stock in a corporation. Similar principles shall apply for purposes of determining ownership of interests in any other entity.



- f. Under Section 512(b)(13)(E), special rules apply to a specified payment under a binding written contract in effect on August 17, 2006 (or a renewal of such a contract under substantially similar terms). Section 512(b)(13) applies only to the excess portion of such payment (the amount that exceeds fair market value, using Section 482 standards). Thus, a specified payment at fair market value isn't taxable under Section 512(b)(13). But if the payment is taxable under Section 512(b)(13)(E) (on the excess portion of the payment), the tax otherwise imposed is increased by 20 percent of the excess. Under Section 512(b)(13)(E)(ii), a taxpayer can't reduce the excess by filing an amended return but can increase it.

## **H. Special Exclusion for a Religious Order**

- (1) Section 512(b)(15) provides an exclusion from unrelated business taxable income from a business carried on by a religious order or by an educational institution maintained by such order. This special exception is intended to cover a trade or business which has been operated since before May 27, 1959, and which consists of providing services under a license issued by a federal regulatory agency. Less than 10 percent of the net income for each taxable year from the business can't be used for activities that aren't related to the purpose constituting the basis for the religious order's exemption. The organization must also establish that the rates or other charges for such services are competitive with the rates or other charges of similar taxable businesses. See Treas. Reg. 1.512(b)-1(j) and S. Rep. No. 91-552, 91st Cong., 1st Sess. 70 (1969), 1969-3 C.B. 469.

## **I. Other Modifications**

- (1) Section 512(b)(16) - (19) contain other, more rarely cited modifications.
  - a. Section 512(b)(16) - Exclusion of gains or losses from the sale, exchange, or other disposition of certain real property acquired from financial institutions in conservatorship or receivership.
  - b. Section 512(b)(17) - Inclusion of certain amounts derived from foreign corporations attributable to insurance income. See Part VI.A.(4) of this document.
  - c. Section 512(b)(18) - Treatment of mutual or cooperative electric companies under Section 501(c)(12)(H).
  - d. Section 512(b)(19) - Exclusion of gain or loss on sale or exchange of certain brownfield sites.
- (2) As these are unusual and if they arise, please contact one of the UBIT Knowledge Management core team members as needed for assistance.

## VII. Exceptions

- (1) Section 513(a) specifically states that the term unrelated trade or business doesn't include:
  - a. Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or
  - b. Any trade or business carried on by an organization described in Section 501(c)(3) or by a governmental college or university described in Section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees, or
  - c. Any trade or business carried on by a local association of employees described in Section 501(c)(4) organized before May 27, 1969, which consists of the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment, or
  - d. Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

### A. Volunteer Labor

- (1) The term "unrelated trade or business" doesn't include any trade or business in which substantially all the work is performed for the organization without compensation. See Section 513(a)(1) and Treas. Reg. 1.513-1(e)(1). For example, an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on the business is performed for the organization by unpaid volunteers, wouldn't be carrying on unrelated trade or business. See Treas. Reg. 1.513-1(e).
- (2) In *St. Joseph Farms of Indiana Brothers of Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner*, 85 T.C. 9 (1985), a Section 501(c)(3) religious order operated a farm that produced livestock and crops that were marketed commercially. The farm was operated by the organization's Brothers, who took a vow of poverty and received no actual salaries. However, the Brothers residing on the farm received food, clothing, shelter, and medical care, regardless of whether they were involved in farm operations. The Tax Court held that although the organization's farming operations constituted unrelated trade or business, the exception for volunteer labor under Section 513(a)(1) applied. The court reasoned that the support provided to the Brothers wasn't compensation for purposes of Section 513(a)(1), because such support would be provided regardless of whether the Brothers were operating the farm. The IRS didn't acquiesce in this decision. See IRS AOD-1986-45 (July 28, 1986).

- (3) A similar case considered by the Tax Court is *Shiloh Youth Revival Centers v. Commissioner*, 88 T.C. 565 (1987). There, the members of a Section 501(c)(3) religious organization engaged in forestry, cleaning and maintenance, painting, and so-called "donated labor" activities. The organization provided its members with food, clothing, shelter, medical care, and other benefits. The court applied *St. Joseph Farms of Indiana* in concluding that the organization's activities constituted unrelated trade or business. However, the court distinguished *St. Joseph Farms of Indiana* for the applicability of the volunteer labor exception under Section 513(a)(1). In *Shiloh*, the court deemed this exception inapplicable because the organization's members wouldn't have received food, clothing, shelter, medical care, and other benefits if they didn't work. In contrast, the Brothers in *St. Joseph Farms of Indiana* would be cared for even if they were no longer involved in the farming operations.
- (4) In *Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner*, 696 F. 2d 372 (5th Cir. 1983), a Section 501(c)(8) organization conducted bingo games where approximately 21 percent of the work was performed for cash compensation and the balance of the work was performed by volunteers who received free drinks for their services. The court held that although free drinks didn't constitute compensation, the approximately 21 percent of the work performed for cash compensation was substantial enough to prevent the bingo game operation from meeting the exception for volunteer labor under Section 513(a)(1).

## **B. Convenience of Members**

- (1) Section 513(a)(2) and Treas. Reg. 1.513-1(e)(2) state that any trade or business carried on by a Section 501(c)(3) organization or by a governmental college or university described in Section 511(a)(2)(B) primarily for the convenience of its members, students, patients, officers, or employees isn't unrelated trade or business. For example, a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing wouldn't be considered unrelated trade or business. See Treas. Reg. 1.513-1(e).
- (2) Any trade or business carried on by a local association of employees described in Section 501(c)(4) organized before May 27, 1969, which consists of the selling of items of work-related clothes and equipment and items normally sold through vending machines, through food-dispensing facilities, or by snack bars, for the convenience of its members at their usual place of employment isn't considered unrelated trade or business. See Section 513(a)(2) and Treas. Reg. 1.513-1(e)(2).
- (3) The following are several authorities illustrating the "convenience exception":
  - a. The leasing of studio apartments and the operation of a dining hall by a Section 501(c)(3) organization constitute unrelated trade or business where occupancy in the apartments isn't primarily for the convenience of its members. See Rev. Rul. 69-69, 1969-1 C.B. 159.

- b. A gift shop operated by the hospital for the convenience of its patients, visitors, and employees, isn't unrelated trade or business. Rev. Rul. 69-267, 1969-1 C.B. 160.
- c. The operation of a cafeteria and coffee shop by a hospital, for the convenience of its employees and medical staff, isn't unrelated trade or business. Rev. Rul. 69-268, 1969-1 C.B. 160.
- d. The operation of a parking lot for patients and visitors by an exempt hospital for the convenience of such patients and visitors isn't unrelated trade or business. Rev. Rul. 69-269, 1969-1 C.B. 160.
- e. The operation of a dining room, cafeteria, and snack bar by an exempt art museum for the convenience of its staff, employees, and members of the public visiting the museum doesn't constitute an unrelated trade or business activity. See Rev. Rul. 74-399, 1974-2 C.B. 172.
- f. In *St. Luke's Hospital of Kansas City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980), the court held, in part, that the hospital's performance of diagnostic laboratory testing upon specimens of patients of the hospital's staff physicians wasn't unrelated trade or business because the testing was performed primarily for the convenience of the hospital's staff physicians, who were "members " for purposes of Section 513(a)(2). Note: Rev. Rul. 85-109, 1985-2 C.B. 165, states that the IRS won't follow that portion of the *St. Luke's Hospital of Kansas City* holding that private patient specimen testing is for the convenience of the hospital's members and therefore not an unrelated trade or business. The IRS position is that hospital staff physicians are neither "members " nor "employees" of the hospital in their capacities as private practitioners of medicine. Therefore, by providing laboratory testing services on tissue specimens referred by its staff physicians in their private capacities, the hospital isn't carrying on an activity primarily for the convenience of its members, officers, or employees within the meaning of Section 513(a)(2).
- g. In *New Jersey Council of Teaching Hospitals v. Commissioner*, 149 T.C. No. 22 (2017), the taxpayer contracted with third-party vendors to provide its members (hospitals and a medical school) access to debt-collection services and group purchasing programs. The taxpayer received fees from the vendors in exchange for administering these programs and promoting the programs to its members. In addition to holding that these fees weren't royalties, the court held that the taxpayer's activities of providing members access to lower cost services, or high-quality vendors weren't carried on primarily for the convenience of its members and therefore constituted unrelated business taxable income.
- h. See also the discussion in Part II.B.3 of this document regarding non-casual sales to persons other than members resulting in a business's failure to qualify for the convenience exception.

## C. Donated Merchandise

- (1) Section 513(a)(3) and Treas. Reg. 1.513-1(e)(3) exclude from the definition of unrelated trade or business any trade or business that consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions. For example, the operation of a thrift shop by a Section 501(c) organization, which sells donated clothes and books to the general public, wouldn't be considered unrelated trade or business. See Treas. Reg. 1.513-1(e) and Rev. Rul. 71-581, 1971-2 C.B. 236.

## D. Public Entertainment Activities

- (1) Section 513(d) states that income from qualified public entertainment activities engaged in by qualified organizations isn't treated as unrelated trade or business.
- (2) As per Section 513(d)(2)(A), a public entertainment activity is any entertainment or recreational activity traditionally conducted at fairs or expositions promoting agricultural and educational purposes. These activities include, but aren't limited to, any activity, one of the purposes of which is to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment.
- (3) As per Section 513(d)(2)(B), qualified public entertainment activities are excluded from unrelated trade or business only when they are conducted by a qualifying organization in:
  - a. Conjunction with an international, national, state, regional, or local fair or exposition,
  - b. Accordance with the provisions of state law which permit the activity to be operated or conducted solely by such an organization, or by an agency, instrumentality, or political subdivision of such state, or
  - c. Accordance with the provisions of state law which permit such an organization to be granted a license to conduct not more than 20 days of such activity on payment to the state of a lower percentage of the revenue from such licensed activity than the state requires from organizations not described in Section 501(c)(3), (4), or (5).
- (4) A qualifying organization is defined in Section 513(d)(2)(C) as an organization described in Section 501(c)(3), (4) or (5) that regularly conducts, as one of its substantial exempt purposes, an agricultural or educational fair or exposition.

For example, activities such as horse racing with pari-mutuel betting as described in Rev. Rul. 68-505 wouldn't be considered unrelated trade or business under this Section provided the above requirements are met.

## E. Convention and Trade Show Activity

- (1) Section 513(d)(3) and Treas. Reg. 1.513-3(b) provide that certain traditional convention and trade show activities carried on by a qualifying organization in connection with a qualified convention or trade show aren't treated as unrelated trade or business and income from such activities isn't subject to the tax imposed by Section 511.
- (2) Section 513(d)(3)(C) defines a qualifying organization as one described in Section 501(c)(3), (4), (5) or (6) that regularly conducts, as one of its substantial exempt purposes, a qualified convention or trade show activity, as described in that Section. The Tax Reform Act of 1986 extended the definition of qualifying organization to organizations described in Section 501(c)(3) and 501(c)(4). The effective date of this provision is October 22, 1986.
- (3) According to Section 513(d)(3)(B), a qualified convention or trade show activity is an activity that meets the following requirements:
  - a. It is conducted by a qualifying organization,
  - b. At least one purpose of the qualifying organization in sponsoring the activity is the promotion and stimulation of interest in, and demand for, the products and services of the qualifying organization's members' industry in general or to educate persons in attendance regarding new developments or products and services related to the exempt activities of the organization, and
  - c. The show is designed to achieve that purpose through the character of the exhibits and the extent of the industry products displayed.
- (4) Per Treas. Reg. 1.513-3(c)(4), for the purposes of this section, convention and trade show activity means any activity of a kind traditionally carried on at shows. The regulations indicate that this includes, but isn't limited to:
  - a. Activities designed to attract to the show members of the sponsoring organization, members of an industry in general, and members of the public, to view industry products or services and to stimulate interest in, and demand for, such products and services,
  - b. Activities designed to educate persons in the industry about new products and services or new rules and regulations affecting the industry, and
  - c. Incidental activities, such as furnishing refreshments, of a kind traditionally carried on at such shows.
- (5) To overcome Congress' specific objection to the taxing of income received by organizations conducting trade shows where selling by exhibitors was permitted, Treas. Reg. 1.513-3(d)(1) states that the rental of display space to exhibitors, including exhibitors who are suppliers, at a qualified trade show or at a qualified convention isn't considered unrelated trade or business even though the exhibitors who rent the space are permitted to sell or solicit orders.

- (6) Treas. Reg. 1.513–3(d) and (e) make it clear that a supplier exhibit may be part of a qualified trade show and, as such, isn't treated as unrelated trade or business. A supplier exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, the members of the qualifying organization in the conduct of such members' own trades or businesses. Income from a supplier show not connected with a qualified trade show is treated as unrelated trade or business income. See examples from the regulations below:
- a. X, an organization described in Section 501(c)(6), was formed to promote the construction industry. Its membership is made up of manufacturers of heavy construction machinery many of whom own, rent, or lease one or more digital computers produced by various computer manufacturers. X is a qualifying organization under Section 513(d)(3)(C) that regularly holds an annual meeting. At this meeting a national industry sales campaign and methods of consumer financing for heavy construction machinery are discussed. In addition, new construction machinery developed for use in the industry is on display with representatives of the various manufacturers present to promote their machinery. Both members and nonmembers attend this portion of the conference. In addition, manufacturers of computers are present to educate X's members. While this aspect of the conference is a supplier exhibit (as defined in paragraph (d) of this Section), income earned from such activity by X won't constitute unrelated business taxable income to X because the activity is conducted as part of a qualified trade show described in Treas. Reg. 1.513–3(c).
  - b. Assume the same facts as in Example a., but the only goods or services displayed are those of suppliers, the computer manufacturers. Selling and order taking are permitted. No member exhibits are maintained. Standing alone, this supplier exhibit (as defined in Treas. Reg. 1.513-3(d)(2) would constitute a supplier show and not a qualified convention or trade show. In this situation, however, the rental of exhibition space to suppliers isn't unrelated trade or business. It is conducted by a qualifying organization in conjunction with a qualified convention or trade show. The show (the annual meeting) is a qualified convention or trade show because one of its purposes is the promotion and stimulation of interest in, and demand for, the products or services of the industry through the character of the annual meeting.
  - c. Y is an organization described in Section 501(c)(6). The organization conducts an annual show at which its members exhibit their products and services in order to promote public interest in the line of business. Potential customers are invited to the show, and sales and order taking are permitted. The organization secures the exhibition facility, undertakes the planning and direction of the show, and maintains exhibits designed to promote the line of business in general. The show is a qualified convention or trade show described in Treas. Reg. 1.513-3(c)(2). The



provision of exhibition space to individual members is a qualified trade show activity and isn't unrelated trade or business.

- d. Z is an organization described in Section 501(c)(6) that sponsors an annual show. As the sole activity at the show, suppliers to the members of Z exhibit their products and services for the purpose of stimulating the sale of their products. Selling and order taking are permitted. The show is a supplier show and doesn't meet the definition of a qualified convention show as it doesn't satisfy any of the three alternative bases for qualification. First, the show doesn't stimulate interest in the members' products through the character of product exhibits as the only products exhibited are those of suppliers rather than members. Second, the show doesn't stimulate interest in members' products through conferences or seminars as no such conferences are held at the show. Third, the show doesn't meet the definition of a qualified show on the basis of educational activities as the exhibition of suppliers' products is designed primarily to stimulate interest in, and sale of, suppliers' products. Thus, the organization's provision of exhibition space isn't a qualified convention or trade show activity. Income derived from rentals of exhibition space to suppliers will be unrelated business taxable income under Section 512.
- (7) Rev. Rul. 2004-112, 2004-2 C.B. 985, provides that supplemental internet activities of a Section 501(c)(6) trade association, extending 3 days before and after its in-person trade show at a physical facility, were qualified convention and trade show activity under Section 513(d)(3)(B). The revenue ruling also holds that internet activities that didn't coincide with a physical trade show weren't qualified convention and trade show activities and weren't excepted from the definition of an unrelated trade or business. A convention or trade show activity which is conducted by a qualifying organization, but which otherwise isn't so qualified under Section 513(d), is considered unrelated trade or business.

## **F. Certain Hospital Services**

- (1) Section 513(e), added by the Tax Reform Act of 1976, provides that the term "unrelated trade or business" doesn't include a tax-exempt hospital's furnishing of the services listed in Section 501(e)(1)(A) to other tax-exempt hospitals. The provision applies if:
  - a. Such services are furnished solely to hospitals that have facilities to serve not more than 100 inpatients,
  - b. Such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption, and
  - c. such services are provided at a fee or cost which doesn't exceed the actual cost of providing such services, such cost including straight line

depreciation and a reasonable amount for return on capital goods used to provide such services.

## G. Certain Bingo and Other Games of Chance

- (1) Section 513(f), added by Public Law 95-502, effective for taxable years beginning after December 31, 1969, provides that certain bingo games are excluded from the definition of unrelated trade or business. Before this law, exempt organizations were subject to the UBIT on the proceeds of bingo games regularly carried on, unless the bingo games were conducted by unpaid volunteers.
- (2) Treas. Reg. 1.513-5(d) defines a bingo game as a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in Treas. Reg. 1.513-5, bingo game means any game of bingo of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. See also Section 513(f)(2).
- (3) The regulations provide that, in order for a bingo game to come within applicable provisions, it must be legal under state and local law, and it must not be in direct commercial competition with similar games conducted by for-profit organizations. See Treas. Reg. 1.513-5(c)(1) and (2) and Section 513(f)(2)(B) and (C). It should be noted that, if bingo is illegal under state law or local law, it is immaterial whether state or local officials enforce the law. See Treas. Reg. 1.513-5(c)(3), Example (2).
- (4) In determining whether bingo games are conducted in competition with commercial entities, Treas. Reg. 1.513-5(c)(2) provides that bingo games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried on (within the meaning of Treas. Reg. 1.513-1(c)) by for-profit organizations in any part of that jurisdiction. Ordinarily, the entire state would constitute the appropriate jurisdiction for making this determination. However, if state laws permit local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if state law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis.
  - a. **Example:** Veterans' organizations Y and X, both tax-exempt organizations, are organized under the laws of State N. State N has a statutory provision that permits bingo games to be conducted by tax-exempt organizations. In addition, State N permits bingo games to be conducted by for-profit organizations in city S, a resort community located in county R. Several for-profit organizations conduct nightly bingo games

in city S. Y conducts weekly bingo games in city S. X conducts weekly bingo games in county R and its game operators are fully compensated for their labor. Because state law confines the conduct of bingo games by for-profit organizations to city S, and because bingo games are regularly carried on there by those organizations, Y's bingo games conducted in city S constitute unrelated trade or business. However, X's bingo games conducted in county R outside of city S do not constitute unrelated trade or business. See Treas. Reg. 1.513-5(c)(3), Example (3).

- (5) A broader exemption from unrelated business applies to certain games of chance conducted in North Dakota. Section 311 of the Deficit Reduction Act of 1984 (as amended by Section 1834 of the Tax Reform Act of 1986) provides that for purposes of Section 513, the term unrelated trade or business doesn't include games of chance conducted by nonprofit organizations if the conduct of such games doesn't violate any state or local law and, as of October 5, 1983, there was a state law (originally enacted on April 22, 1977) in effect which permitted only nonprofit organizations to conduct such games. This provision applied to games of chance conducted after June 30, 1981, in taxable years ending after that date. The amendment in the Tax Reform Act of 1986 limited the exception to games of chance conducted in the State of North Dakota.

## **H. Certain Pole Rentals**

- (1) Section 513(g), added to the Code by P.L. 96-605, states that, in the case of mutual or cooperative telephone or electric companies exempt under Section 501(c)(12), the term "unrelated trade or business " doesn't include engaging in qualified pole rentals (as defined in Section 501(c)(12)(D)).
- (2) The term "qualified pole rental " is defined in Section 501(c)(12)(D) as any rental of a pole (or other structure used to support wires) if such pole (or other structure) is used:
  - a. By the telephone or electric company to support one or more wires that are used in providing telephone or electric services to its members, and
  - b. Per the rental to support one or more wires (in addition to the wires described above) for use in connection with the transmission by wire of electricity or of telephone or other communications.
- (3) In this context, "rental" includes any sale of the right to use the pole (or other structure).
- (4) This provision is effective for all taxable years beginning after December 31, 1969.

## **I. Certain Distributions of Low-Cost Articles Without Obligation to Purchase and Exchanges and Rentals of Member Lists**

- (1) Treas. Reg. 1.513-1(b) states that where an activity doesn't possess the characteristics of a trade or business per Section 162, such as when an

organization sends out low-cost articles incidental to the solicitation of charitable contributions, the UBIT doesn't apply because the organization doesn't compete with taxable organizations.

- (2) Defining the term "low-cost article" presented difficulties for the IRS and the courts. In *Hope School v. United States*, 612 F. 2d 298 (7th Cir. 1980), the court held that a tax-exempt school's solicitation of contributions through the mailing of greeting cards to potential contributors didn't constitute unrelated trade or business. In the court's view, the organization wasn't selling greeting cards but was, instead, distributing them incidental to the solicitation of charitable contributions. The court focused on the unfair competition question, holding that no unfair competition was involved. The court emphasized that the net proceeds were used for the benefit of the school rather than reinvestment in the greeting card business.
- (3) A similar approach was taken by the court in *Veterans of Foreign Wars of the United States v. United States*, 601 F. Supp. 7 (W.D. Mo. 1984). Citing *Hope School*, the court found that the greeting cards were distributed as low-cost articles incidental to the solicitation of contributions. In addition, the court noted that the organization didn't reinvest proceeds into its greeting card program, thereby gaining no competitive advantage, which indicates that it wasn't operating a trade or business for purposes of the tax on unrelated business income.
- (4) In *Disabled American Veterans v. United States*, 650 F. 2d 1178 (Ct. Cl. 1981), the court considered whether amounts received from the DAV's merchandise premiums and mailing list rentals constituted unrelated business taxable income. Under DAV's Special Solicitation program, requests for contributions were accompanied by books, maps and charts, or wrist calendars. The premiums were offered for contributions in stated amounts of \$2.00, \$3.00, \$5.00 or more. The Court of Claims stated that what is necessary to constitute a trade or business for purposes of the tax on unrelated business income is that an activity be operated in a competitive commercial manner. Applying this test, the court found that the contributions required for both the \$2.00 and \$3.00 premiums were substantially in excess of their retail value and, therefore, no trade or business was present. However, the contributions required for the \$5.00 premiums weren't so greatly in excess of their retail value and, therefore, amounts attributable to the \$5.00 premiums were derived from a trade or business. DAV also rented out its donor mailing list. Income from the exchanges and rentals of member lists was held to be unrelated business taxable income. In response to this court decision, Congress enacted Section 513(h)(1)(B), which provides that for exempt organizations that are eligible to receive deductible contributions under Section 170(c)(2) or (3), the term "unrelated trade or business" doesn't include any trade or business which consists of exchanging or renting members' or donors' names and addresses with or to another such organization. In accordance with this provision, an exempt organization eligible to receive deductible contributions under Section

170(c)(2) or (3) that exchanges its member lists with "another such organization," or that rents its member lists to "another such organization" doesn't engage in unrelated trade or business. See also *Common Cause v. Commissioner*, 112 T.C. 332 (1999) (enactment of Section 513(h) doesn't mean that mailing list rentals that do not fall within that provision are always unrelated business taxable income and not royalties) and *Planned Parenthood Federation of America, Inc. v. Commissioner*, T.C. Memo. 1999-206. See also the discussion of Royalties in Part VI.A.2 of this document for cases involving mailing list rentals.

- (5) In order to clarify the definition of low-cost articles, Congress enacted Section 513(h) as part of the Tax Reform Act of 1986. Section 513(h)(1)(A) provides that, in the case of an organization which is described in Section 501 and contributions to which are deductible under Section 170(c)(2) or (3), the term "unrelated trade or business" doesn't include activities relating to the distribution of low-cost articles, if the distribution of such articles is incidental to the solicitation of charitable contributions. A "low-cost article" is defined in Section 513(h)(2)(A) as any article with a cost of \$5.00 or less to the organization distributing the item (or on whose behalf such item is distributed). Items are aggregated in a calendar year where more than one item is distributed to a single distributee. The aggregate of the items is treated as one article for purposes of the \$5.00 limit. See Section 513(h)(2)(B). Section 513(h)(2)(C) indexes the \$5.00 limit with a cost-of-living adjustment for years after 1987. For taxable years beginning in 2023, for purposes of defining the term 'unrelated trade or business' for certain exempt organizations under Section 513(h)(2), 'low cost articles' are articles costing \$12.50 or less. See Rev. Proc. 2022-38, Section 3.34(1). An annual revenue procedure is published with updated inflation-adjusted amounts.
- (6) A distribution of low-cost articles is treated as a distribution incidental to the solicitation of charitable contributions only if:
  - a. The distribution isn't made at the request of the distributee,
  - b. The distribution is made without the express consent of the distributee, and
  - c. The distributed articles are accompanied by a request for a charitable contribution by the distributee to the distributing organization and by a statement that the distributee may retain the low-cost article regardless of whether the distributee makes a charitable contribution to the distributing organization. See Section 513(h)(3).
- (7) The Tax Court considered whether an organization's Christmas card program resulted in unrelated business taxable income in *Veterans of Foreign Wars, Department of Michigan v. Commissioner*, 89 T.C. 7 (1987). The Veterans of Foreign Wars (VFW) entered into a contract with a commercial organization, which agreed to prepare boxes of Christmas cards and send them to individuals appearing on a list provided by VFW. Each package sent to an individual

appearing on the list included a cover letter, a box of 20 Christmas cards, a return envelope, and a remittance card. The cover letter asked the recipient to pay \$2.00 in 1975 and \$3.00 in 1976 and 1977 and stated that contributions were tax deductible. The commercial organization also sent out reminder notices to those who didn't respond initially. VFW was involved in the Christmas card program for about one week per month from September through February of each year. Approximately 50,000 boxes of cards were shipped during each of the three years. The commercial organization provided similar services to other exempt organizations and, during the three years in question, its share of the Christmas card market was 1.52 percent, 1.84 percent, and 2.12 percent, respectively. On these facts, the Tax Court concluded that VFW conducted the Christmas card program:

- a. With the predominant intent of producing income,
  - b. The Christmas card program was in substance the regularly carried on sale of goods,
  - c. The program was in competition with Christmas cards marketed by commercial entities,
  - d. The program wasn't substantially related to VFW's exempt purposes, and
  - e. Those paying more than the \$2.00 or \$3.00 amounts requested made a gift to VFW.
- (8) With regard to the trade or business issue, the court stated that it believed VFW conducted the Christmas card program in order to produce income. All of the facts indicated that there was a trade or business under Section 513(a) and (c). The court also rejected the organization's argument that the Christmas cards were low-cost articles sent incidental to the solicitation of charitable contributions as the amounts solicited by the organization were 'within a reasonable range' of the retail values of the Christmas cards. Therefore, the court found that the Christmas cards weren't low-cost articles and held that the low-cost article exception didn't apply. In a footnote, the court stated that the distribution of the Christmas cards wouldn't qualify under Section 513(h) (see below), and, in any event, this provision applies only to distributions made after October 22, 1986. The distributions in this case occurred prior to this date.

## **J. Qualified Sponsorship Payments**

- (1) Section 513(i), added to the Code by P.L. 105-34 in 1997, provides that the term "unrelated trade or business" doesn't include the activity of soliciting and receiving "qualified sponsorship payments."
- (2) A qualified sponsorship payment is any payment made by any person engaged in trade or business (sponsor) to a tax-exempt organization in return for the organization's use or acknowledgment of the sponsor's name or logo (or product lines), where there is no arrangement or expectation that such person

will receive any other substantial return benefit. See Section 513(i)(2)(A) and Treas. Reg. 1.513-4(c)(1).

- (3) Use or acknowledgment doesn't include advertising the sponsor's products or services, including endorsement or other inducements to buy, sell or use such products or services. See Section 513(i)(2)(A). A more detailed discussion of what a use or acknowledgment does and doesn't include is set forth in Treas. Reg. 1.513-4(c)(2)(iv). Also, payments contingent on the level of attendance at one or more events, on broadcast ratings, or on other factors indicating the degree of public exposure to the sponsored activity aren't qualified sponsorship payments. Treas. Reg. 1.513-4(e)(2).
- (4) Section 513(i) doesn't apply to payments made in connection with qualified convention and trade show activities, nor to income derived from the sale of advertising or acknowledgments in exempt organization periodicals. See Treas. Reg. 1.513-4(b). In some cases, a mere listing of multiple donors in a periodical might not constitute unrelated business. See Rev. Rul. 76-93, 1976-1 C.B. 170, clarifying Rev. Rul. 74-38, 1974-1 C.B. 144.
- (5) In some situations, a payment may be a qualified sponsorship payment in part. If there is an arrangement or expectation that the sponsor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that the exempt organization establishes is in excess of the fair market value of the substantial return benefit is a qualified sponsorship payment. Treatment of the remaining portion (and treatment of any other payment that doesn't qualify as a qualified sponsorship payment) is determined by applying Sections 512-514. See Treas. Reg. 1.513-4(d).

## **K. Special Rule for Certain Trusts**

- (1) The term "unrelated trade or business" has a special meaning for a trust computing its unrelated business taxable income under Section 512 for purposes of Section 681 (relating to the limitation on the charitable deduction by a trust), an exempt trust described in Section 401(a) or a Section 501(c)(17) trust. Any trade or business regularly carried on by one of these trusts, or by a partnership of which it is a member, is unrelated trade or business. See Section 513(b). The same rule applies to an individual retirement account (which is subject to UBIT under Section 408(e)). See Treas. Reg. 1.513-1(f). In addition, the exclusions of Section 513(a) aren't applicable to these trusts. See *Cooper Tire and Rubber Co. Employees' Retirement Fund v. Commissioner*, 36 T.C. 96 (1961), *aff'd*, 306 F. 2d. 20 (6th Cir. 1962).

## **VIII. Taxes and Returns**

- (1) An exempt organization that has \$1,000 or more of gross income from an unrelated business must file Form 990-T. See Treas. Regs 1.511-3(b), 1.6012-



2(e) and 1.6012-3(a)(5). An organization must pay estimated tax if it expects its tax for the year to be \$500 or more. See Section 6655(f).

- (2) The obligation to file Form 990-T is in addition to the obligation to file the annual information return, Form 990, 990-EZ or 990-PF. Each organization must file a separate Form 990-T, except title holding corporations and organizations receiving their earnings that file a consolidated return. See Treas. Regs 1.511-3(b), 1.6012-2(e) and 1.6012-3(a)(5)(g)(3) and Part I.D.3 of this document.
- (3) For most exempt organizations, Form 990-T is due annually by the 15<sup>th</sup> day of the 5<sup>th</sup> month after the end of its tax year. See Section 6072(c) and Treas. Reg. 1.6072-2(c).
- (4) As mentioned previously, an exempt organization claims the specific deduction of \$1,000 on the Form 990-T and only one specific deduction may be taken, regardless of the number of unrelated businesses conducted. Section 512(b)(12) provides for a \$1,000 deduction from gross income in computing unrelated business taxable income, except for purposes of computing the net operating loss under Section 172.

## A. Tax Rates

- (1) All organizations subject to tax under Section 511, except trusts described below, are taxable at corporate rates under Section 11 on unrelated business taxable income. See Section 511(a)(1) and Treas. Reg. 1.511-1.
  - a. For corporate (non-trust) organizations and state colleges and universities, for tax years beginning after December 31, 2017, the tax rate on unrelated business taxable income is a flat 21%.
- (2) Trusts exempt from taxation under Section 501(a) and which, if not exempt, would be taxable as trusts under subchapter J, are taxable at trust rates under Section 1(e) on unrelated business taxable income. See Section 511(b)(1) and Treas. Reg. 1.511-2(b). The deduction for personal exemption provided in Section 642(b) in the case of a trust taxable under subchapter J, chapter 1 of the Code, isn't allowed in computing unrelated business taxable income.
- (3) The foreign tax credit is available to organizations filing Form 990-T to the extent provided in Section 901. Section 515 provides that the term "unrelated business taxable income" is considered synonymous with "taxable income" for purposes of an exempt organization claiming the foreign tax credit under Section 901 and 904.
  - a. Other tax credits may also be available. For example, see Rev. Rul. 82-218, 1982-2 C.B. 30, and Rev. Rul. 2003-64, 2003-1 C.B. 1036. See also the discussion in Part III.N of this document.

## B. Tax Preferences

- (1) Trusts liable for tax on unrelated business taxable income may be liable for alternative minimum tax ("AMT") on certain adjustments and tax preference

items under Section 55. Only those items of tax preference which enter into the computation of unrelated business taxable income are taken into account in computing the AMT. See Section 55(b)(2).

- (2) For tax years beginning before 2018, the AMT applies to corporations, subject to an exemption for small corporations under Section 55(e). Section 12001 of the TCJA eliminated the AMT on corporations under Section 55(a) for tax years beginning after January 1, 2018. For taxable years beginning after December 31, 2022, Section 10101 of the Inflation Reduction Act of 2022 established a new corporate AMT, which generally applies to corporations with more than \$1 billion of income on their financial statements (which, for corporations subject to tax under Section 511, includes only income from an unrelated trade or business (including debt-financed property)). See Section 56A(c)(12) and Notice 2023-7, 2023-3 IRB 390.

### **C. Returns – Forms and Due Dates**

- (1) Every domestic and foreign organization exempt under Section 501(a) (except instrumentalities of the United States) must file a return on Form 990-T, Exempt Organization Business Income Tax Return, when the sum of its gross income from an unrelated trade or business and unrelated business taxable income is \$1,000 or more. An exempt organization files a single Form 990-T. The 990-T was revised in 2020, and among the revisions was the creation of Schedule A, Unrelated Business Taxable Income From an Unrelated Trade or Business. This schedule is where an organization reports the income and expenses for each of its unrelated businesses. A separate Schedule A would be attached to the 990-T for each unrelated business activity. See Treas. Reg. 1.512(a)-6 for information about how to identify separate unrelated trades or businesses, discussed in Part III.G of this document.
- (2) Mandatory electronic filing of Form 990-T started in February 2021. Limited exceptions apply. See the Instructions for Form 990-T for more information. The obligation to file Form 990-T is in addition to the obligation to file an information return (i.e., Form 990). See Treas. Reg. 1.6012-2(e) and 1.6012-3(a)(5).
- (3) Each organization must file a separate Form 990-T, except Section 501(c)(2) title-holding corporations and organizations receiving their earnings that file a consolidated return under Section 1501 as discussed in Part I.D.3 of this document.
- (4) The various provisions of law relative to accounting periods, accounting methods, assessment, and collection penalties, etc., which apply to tax returns generally are equally applicable to returns filed on Form 990-T. See Treas. Reg. 1.511-3(a) and (c).
- (5) Any tax due with Form 990-T must be paid in full when the return is filed, but no later than the date the return is due (determined without extensions). See Section 6151(a). Taxpayers must pay the tentative tax (an estimate) with a Form 8868 request for extension.

- (6) All organizations exempt under Section 501(c) (other than employees' trusts described in Section 401(a)) that are subject to unrelated business income tax must file Form 990-T by the fifteenth day of the fifth month after the close of their tax year. See Section 6072(e).
- (7) The filing of an information return on Form 990 (or any other return required by Section 6033 by an organization exempt from income tax under Section 501(a)) doesn't start the running of the statute of limitations for purposes of assessment of the unrelated business income tax required to be reported on Form 990-T, unless the return discloses sufficient facts to apprise the IRS of the potential existence of unrelated business taxable income. When the Form 990, Return of Organization Exempt From Income Tax, is filed before the Form 990-T, the statute of limitations for purposes of assessment of unrelated business income tax starts running with the Form 990 filing and discloses the gross receipts from the activity. See Rev. Rul. 69-247, 1969-1 C.B. 303. modifying Rev. Rul. 62-10, 1962-1 C.B. 305.

#### **D. Statute of Limitations**

- (1) Section 6501(a) provides the general rule that the amount of any tax shall be assessed within three years after the tax return is filed. Section 6501(b)(1) provides that a return is deemed filed on the due date if it is filed early but is deemed filed on the date filed if it is filed late.
- (2) Section 6501(c) lists several exceptions that allow assessment to be made at any time. These include a false or fraudulent return with the intent to evade tax; a willful attempt to evade tax; failure to file a return; and assessment of tax on termination of private foundation status. The statutory period may also be extended by written agreement (on Form 872, Consent to Extend the Time to Assess Tax or Form 872-A, Special Consent to Extend the Time to Assess Tax) between the taxpayer and the IRS. If the period of limitations is extended by agreement, the tax may be assessed any time within the period agreed on, and the period may be extended by subsequent written agreements made within the period previously agreed on. See Treas. Reg. 301.6501(c)-1(d).
- (3) Section 6501(g)(2) and Reg. 301.6501(g)-1(b) provide that the period of limitations for assessing income tax starts when an organization, believing in good faith that it is an exempt organization, files a return as such, even if the organization is later held to be a taxable organization for the taxable year for which the return is filed. Rev. Rul. 60-144, 1960-1 C.B. 636, provides that Section 6501(g)(2) applies even though the organization has not been recognized as exempt when the return is filed, and Treas. Reg. 1.6033-2(c) requires an organization claiming exempt status prior to recognition to file a return required by Section 6033. Section 6501(g)(2) doesn't, however, relieve an organization that has not established its exempt status from the requirement that it file income tax returns and pay any tax due.

- (4) The "failure to file" exception of Section 6501(c)(3) doesn't apply to related returns (Form 990-T, Form 1120-POL, etc.) required of an exempt organization if the organization filed in good faith a Form 990-series information return that discloses information sufficient to apprise the IRS of the nature and extent of the items that should have been reported on a related return. This has been the position of IRS since the publication of Rev. Rul. 69-247, 1969-1 C.B. 303, which announced that the IRS will follow the decision in California Thoroughbred Breeders Association v. Commissioner, 47 T.C. 335 (1966), if certain conditions are met.
- (5) In California Thoroughbred Breeders, the IRS attempted to assess unrelated business income tax on a Section 501(c)(5) organization's income from horse sales. The tax was assessed more than three years after the organization filed Form 990 for the year in issue. The organization didn't file Form 990-T for the year but reported the income from the horse sales on its Form 990. The organization asserted the defense that the three-year period of limitations barred assessment. The IRS contended that the period of limitations didn't apply because the organization didn't file Form 990-T, and the filing of Form 990 didn't start the period of limitations for assessment of unrelated business income tax. The court held that the period of limitations for assessment of unrelated business income tax on the horse sale income started when the organization filed Form 990, which reported the nature and amount of the income. The court found as fact that the organization determined in good faith that it was exempt and had no taxable income. Therefore, the organization determined in good faith that it wasn't required to file any return other than Form 990.
- (6) In Rev. Rul. 69-247, 1969-1 C.B. 303, the IRS set out the information an organization's annual information return must disclose to bring the return under the holding of the court in California Thoroughbred Breeders. The return (filed in good faith) must state the nature of the income-producing activity with sufficient specificity to enable the IRS to determine whether the income is from a related activity and must disclose the gross receipts from the activity. If the information return doesn't disclose facts sufficient to apprise the IRS of the nature and amount of the income, the IRS follows the position of Rev. Rul. 62-10, which is that the filing of the information return doesn't start the period of limitations for purposes of assessment of unrelated business income tax.

## **E. Taxes**

- (1) This section focuses on how to calculate and assess the tax once you have determined that there is an unrelated business income tax issue. See Section 511(a)(1).

### **E.1. Calculation of Taxes**

- (1) All organizations subject to the tax on unrelated business income, except the exempt trusts described in Section 511(b)(2), are taxable at corporate rates on

that income. See Treas. Reg. 1.511-1 and see the discussion in Part VIII. A. of this document. All exempt trusts subject to the tax on unrelated business income that, if not exempt, would be taxable as trusts are taxable at trust rates on that income. However, an exempt trust may not claim the deduction for a personal exemption that is normally allowed to a trust.

- (2) Under Section 512(a)(6), an organization that conducts more than one unrelated trade or business calculates its UBTI as the sum of the UBTI calculated separately for each unrelated trade or business, and when calculating this sum, the UBTI from any of the separate trades or businesses can't be less than zero. The tax computed on the total UBTI can be reduced by any applicable tax credits, including the general business credits (such as the investment credit) and the foreign tax credit. See Schedule A (Form 990-T). The UBTI with respect to any such trade or business shall not be less than zero when computing total UBTI. See the discussion in Part III.G of this document.

## **IX. Examination Techniques**

- (1) This section provides techniques to identify potential unrelated business income. It also provides issue indicators and examination tips when reviewing an unrelated business income issue. See Sources of Unrelated Business Income (UBI) Lead Sheet (Exhibit X.D of this document).

### **A. Analyze Activities for UBI**

- (1) Identify each separate trade or business using the first two digits of the NAICS 2-digit code that most accurately describes the unrelated trade or business based on the more specific NAICS code for each year under exam.
- (2) Calculate UBI by totaling the UBI for each separate trade or business using the first two digits of the NAICS code that most accurately describes the unrelated trade or business and subtracting the total allowable deductions.
  - a. Investigate the source of all allocated expenses.
  - b. Identify the allocation method used to allocate the expenses between related and unrelated use.
  - c. Determine if the activity is directly connected to the unrelated business activity.
  - d. Determine the history behind UBI activities which resulted in losses. A pattern of losses for five or more years indicates a lack of profit motive, justifying a disallowance of that activity from the return.
  - e. Check the calculations which led to net operating losses reported on returns.
  - f. Substantiate the expenses the business incurred over the years resulting in net operating losses. Look beyond the calculations.

- g. Examine each UBI activity to determine if each “unrelated” activity is properly siloed.
- (3) Identify UBI activities reported that involve dual use of facilities.
  - (4) Review the organization’s activities to ensure that it reported all unrelated business activities producing income on Form 990-T.
  - (5) Identify possible sources of rental income from debt financed property.
  - (6) Review newsletters and other publications to check for taxable advertising. Note that the qualified sponsorship exception under Section 513(i) doesn’t apply to advertising in a periodical unless related to, and primarily distributed in connection with, a specific event conducted by the exempt organization.
  - (7) Review organization’s website for advertising and other indications of unrelated trade or business. See the Advertising Lead Sheet (Exhibit X.F of this document).
  - (8) Look for indications of other unrelated activities.

#### **A.1. Section 501(c)(5) Activities – Potential UBI**

- (1) Identify possible sources of rental income and winter storage fees.
- (2) Look for provision of goods and services to others.
- (3) Associate member dues are excluded from UBI for exempt agricultural or horticultural organizations if they are \$100 or less. See Section 512(d). Caution: See annual inflation adjustment revenue procedure (latest is Rev. Proc. 2022-38, 2022-45 I.R.B. 445) for inflation-adjusted limitation for annual dues under this paragraph.

#### **A.2. Section 501(c)(6) Activities – Potential UBI**

- (1) Review organization’s website and other publications which may name the products or services of members only. See Rev. Rul. 79-370, 1979-2 C.B. 238 and Rev. Rul. 65-14, 1954-1 C.B. 236.
- (2) Analyze income from members (other than dues) to identify any payments for particular or individualized services.
- (3) Review the dues account in the cash receipts journal for associate member dues.
- (4) Look for multiple listing and coupon redemption service.



### A.3. Section 501(c)(7) Activities – Potential UBI

- (1) Examine the cash receipts journal and related supporting documents to determine the club income's size, extent, and nature and whether it's related to the organization's exempt purpose.
- (2) Review the balance sheet assets to identify any that might produce investment income. Investment income not set aside is generally taxable.
- (3) Identify any income from nonmembers or the general public. Amounts a member or spouse paid for dependents are considered exempt function income. Also, amounts the member's employer or gratuitous donor paid for the member's benefit, typically would constitute exempt function income. See Rev. Proc. 71-17 and Part IV.B.3 above.
- (4) Identify green fees paid for any golf rounds played by bona fide guests possibly included in the total green fees. Even though green fees are usually only paid by, or for, nonmembers, the entire amount isn't necessarily nonmember income as the member may have paid some of the green fees for bona fide guests.
- (5) Analyze how the club treats nonmembers as guests. Ensure they have properly treated them as guests and complied with the recordkeeping requirements of Rev. Proc. 71-17.
- (6) Identify any income from nontraditional business activities. Usually, don't consider income from these activities exempt function income. This holds true even if the activity is conducted with members, for example, selling package liquor to members for use off-premises and selling advertising space in the organization's newsletter to members and nonmembers.
- (7) Review comparative balance sheets and notes to the financial statement to identify any sales of assets. Section 512(a)(3)(D) permits non-recognition of gains from certain sales when proceeds are reinvested in property used exclusively for exempt Section 501(c)(7) purposes. See Part IV.D of this document, Gain on Sale of Assets. When they must recognize gain, however, it is treated as UBI. See *Tamarisk Country Club v. Commissioner*, 84 T.C. 756 (1985).
- (8) Determine whether the taxpayer and another social club merged and whether any excess assets have been sold or whether the social club has sold its assets and ceased operations. In the latter case, in addition to determining whether the club has UBI from the sale of its assets and real property, review whether the club has made distributions to members. If so, determine whether the organization issued Forms 1099 to the members because these distributions may create taxable income under Section 301.
- (9) Ensure all UBI is properly reported on Form 990-T and on Form 990. If there are indications that the organization sold property, check the returns to make sure the organization has notified the IRS of the sale. Verify that the organization has properly determined the property's adjusted basis, including



adjusting the basis by depreciation for all earlier tax years, in computing its gain.

#### **A.4. Section 501(c)(8) and 501(c)(10) Activities – Potential UBI**

- (1) Identify sales to the general public, which are typically from a bar or restaurant.
- (2) Look for rental income from debt-financed properties rented to non-members.
- (3) Analyze gaming activities to see if they are open to the public.

#### **A.5. Section 501(c)(14) Activities – Potential UBI**

- (1) Analyze each activity and all the facts and circumstances surrounding that activity to figure out the activity's relation to the organization's exempt purpose.
- (2) Generally, income from the marketing of insurance products as well as certain ATM fees would be considered UBI:
  - a. Automobile warranties,
  - b. Dental insurance,
  - c. Cancer insurance,
  - d. Accidental death and dismemberment insurance,
  - e. Life insurance,
  - f. Health insurance,
  - g. ATM "per transaction" fees from nonmembers.
- (3) Generally, credit life and disability insurance, and GAP auto insurance wouldn't be UBI if sold to members.

### **B. Issue Indicators**

- (1) Does the Form 990, Form 990-EZ, Short Form Return of Organization Exempt From Income Tax or Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation show any rental income? If so, then check the balance sheet for debt that might be associated with that income.
- (2) The purchase of common stocks or bonds with borrowed funds (stocks purchased on margin) gives rise to debt-financed property. An examination of the brokerage statements for the year(s) of examination should reveal any margin accounts or pledges of securities. Expense analysis should disclose any interest payments. The Board of Directors Finance Committee (or a similar type of committee) minutes should disclose the investments and any encumbrances.
- (3) Unrelated Business Income reported from gaming with minimal or no reported Unrelated Business Taxable Income.
- (4) Income from gaming reported on Form 990 or discovered during an examination of the organization.

- (5) Expenses reported on Form 990-T for gaming licenses and/or prizes.
- (6) Charitable contributions reported on Form 990-T in excess of 10% of the reported Unrelated Business Income.
- (7) Gaming advertised in publications or at facility.
- (8) Evidence of gaming equipment found during tour of facility.

### **C. Examination Tips**

- (1) Ask questions about how the activity is conducted to determine the organization's motive for conducting the activity. Is the activity profit-motivated and does it have characteristics of an activity conducted by a for-profit entity? The comparison is both operational and financial. Treas. Reg. 1.183-2 provides a good discussion of factors to consider when determining if an activity is profit-motivated.
  - a. The way the taxpayer carries on the activity.
  - b. The expertise of the taxpayer or his advisors.
  - c. The time and effort expended by the taxpayer in carrying on the activity.
  - d. The expectation that assets used in the activity may appreciate.
  - e. The success of the taxpayer in carrying on other activities.
  - f. The taxpayer's history of income or losses with respect to the activity.
  - g. The amount of occasional profits, if any, from the activity.
  - h. The financial status of the taxpayer.
  - i. Elements of personal pleasure or recreation.
- (2) Isolate the financial transactions of the activity to derive a profit or loss for the activity. A good starting point is to analyze the activity budget or departmental schedules of the financial statements.
- (3) Examine the financial statements, particularly the balance sheet accounts, for income-producing assets and long-term liabilities. The income statement should be examined for passive forms of income that is generally produced by debt-financed property. The assets should be closely examined even though the liability accounts do not show any encumbrances that could be attached to assets.
- (4) Investments in partnerships as either a limited or general partner can create debt-financed income or income from the operation of a business. See Parts II.A.2 and III.J. Any time there is an investment in a partnership, the partnership return (Form 1065) must be secured to determine if there is any UBI. Also, inspect the K-1 received by the organization from the partnership.

- (5) Most loans on property require insurance, so you should review the insurance policies of the organization to see who the "loss payees" are.
- (6) Public property records will contain information on lien holders and mortgagors. These should be reviewable online.
- (7) Secure a description of the duties of employees, contractors, and volunteers for the year under examination.
- (8) Secure any time records kept of workers' time for the year under examination.
- (9) Review minutes from board meetings.
- (10) Review sources of income for possible unrelated business income.
- (11) Interview organization officials regarding operations.
- (12) Tour facilities looking for possible sources of unrelated business income. For instance, bingo operation with a concession stand open to the public, veterans' organization with a restaurant/bar area open to the public, etc.
- (13) Check to see whether the unrelated business income source was possibly disclosed on the Form 990, thereby starting the statute timeline (see Statute of Limitations discussion in Part VIII.D above).
- (14) If the organization is conducting gaming activities or there is evidence of potential gaming activities, then use the following tips:
  - a. Review the financial information reported on the organization's application for a gaming license.
  - b. Obtain a copy of the state's (or local jurisdiction's) laws and regulations related to charitable gaming activities and licensure.
  - c. Obtain a copy of the organization's charitable gaming license.

## **X. Exhibits**

- (1) This section provides exhibits on computations for UBI or UBTI.

### **A. Illustration of Computation of Unrelated Business Taxable Income Where There is Exempt Function Income – Section 501(c)(7) Organization.**

- (1) S, a social club, operates a restaurant and bar for members and their guests. Nonmembers are admitted to the restaurant and bar only if accompanied by a member. S is supported by annual dues and amounts received in consideration for food and beverages. S doesn't normally receive payment for food and beverages at the time they are furnished but, rather, bills its members monthly for such items. Because some members prefer not to be billed, S has facilities for receiving cash payments. Although most cash payments are made by the members and include all expenses incurred by themselves and their guests,

some nonmembers insist on paying their own expenses directly to the club. S didn't set aside any amounts under Section 512(a)(3)(B).

(2) During the year, S received the following amounts of gross income:

<b>S's Gross Income</b>	
Dues	\$55,000
Receipts from members from sale of food and beverages	\$195,000
Receipts from nonmembers from sale of food and beverages (NAICS 720000)	\$5,000
Interest (901101)	<u>\$500</u>
Total	<u>\$255,500</u>

(3) S incurred expenses during the year of \$180,000 from the operation of the restaurant and bar and \$72,000 from the performance of other exempt activities. The portion of the expenses directly connected with the furnishing of food and beverages to nonmembers who pay their own bills was \$4,500. No expenses were incurred with respect to the interest income. S computes its UBTI as follows:

<b>S's Unrelated Business Taxable Income</b>		
Gross income		\$255,500
Reduced by exempt function income:		
Gross income from member dues	\$55,000	
Gross receipts from members	<u>\$195,000</u>	<u>\$250,000</u>
Gross income (excluding exempt function income)		\$5,500
Less:		
Expenses directly connected (NAICS 720000)	\$4,500	
Specific deduction allowed by IRC 512(b)(12)	<u>\$1,000</u>	<u>\$5,500</u>
Unrelated business taxable income		\$0

**B. Illustration of General Computation of Unrelated Business Taxable Income Where There is a Set-Aside of Income – Section 501(c)(7) Organization.**

(1) An exempt social club described in Section 501(c)(7) derived income and incurred expenses during the year in the following manner:

<b>Exempt Social Club Income and Expenses</b>	
Gross income from:	
Member dues	\$225,000
Property rental to nonmembers (NAICS 720000)	\$6,500
Investments (NAICS 901101)	\$3,000
Deductions directly connected with gross income from:	
Member dues	\$225,000
Property rental to nonmembers (NAICS 720000)	\$6,500
Investments (NAICS 901101)	\$3,000
Income set aside for educational purposes	\$2,000

(2) This organization's UBTI is computed as follows:

<b>Exempt Social Club Unrelated Business Taxable Income</b>		
Gross income		\$234,500
Reduced by exempt function income:		
Gross income from members	\$225,000	
Income set aside	<u>\$2,000</u>	<u>\$227,000</u>
Gross income (excluding exempt function income)		\$7,500
Less:		
Section 162 deductions for debt-financed property (Maintenance, taxes etc.)	\$4,000	
Section 162 deductions for investments	<u>\$200</u>	<u>\$4,200</u>
Total		\$3,300

Less: Specific deduction allowed by Section 512(b)(12)		<u>\$1,000</u>
Unrelated business taxable income		<u>\$2,300</u>

### C. Illustration of Nonrecognition of Gain on Sale of Property Used Directly in Furtherance of the Exempt Function – Section 501(c)(7) Organization.

- (1) N, a social club, purchased a building and land for use as a golf course in 1996 for \$100,000. On April 1, 2018, N sold the entire tract, in one transaction, for \$250,000 and purchased another tract for \$120,000. N then spent \$105,000 constructing a golf course and club house on the new tract. Construction was completed in 2018. Between February 1, 2018, and April 1, 2018, N incurred \$4,000 of expenses in negotiating the sale of its old property and \$1,000 of noncapital expenses for work performed on the old property to assist in its sale. The club computes its recognizable gain from the sale of the property as follows:

N's Recognizable Gain	
Proceeds from sale of old property	\$250,000
Less: selling expenses	<u>\$4,000</u>
Amount realized	\$246,000
Less: basis	<u>\$100,000</u>
Gain realized	\$146,000
Amount realized	\$246,000
Less: fixing-up expenses	<u>\$1,000</u>
Sales price	\$245,000
Cost of purchasing other property	<u>\$225,000</u>
Gain recognized	\$20,000
Gain realized but not recognized (\$146,000 – \$20,000)	\$126,000
N computes its adjusted basis in the other property as follows:	
Cost of purchasing other property	\$225,000
Less: gain realized but not recognized	<u>\$126,000</u>
Adjusted basis of other property	\$99,000

## D. UBI Sources Lead Sheet

<b>Sources of Unrelated Business Income (UBI) Lead Sheet</b>		
<b>Conclusion:</b> (Reflects the final determination on the organization).		
<p>The following techniques aren't intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.</p> <p><b>Reference:</b> UBIT K-Net, TCJA Library, Notice 2018-67-Interim Guidance, Pub. 598, Form 990-T Instructions</p>		
<b>Guidelines</b>		
<b>Key Items:</b>	<b>Yes/ No/ N/A</b>	<b>WP Ref</b>
1. Determine whether the taxpayer has filed Form 990-T and verify the statute date.		
2. Identify the sources of the UBI.		
3. Verify whether the organization conducted UBI activities with gross revenue greater than \$1,000.		
4. Identify any sources of the UBI not listed on the Form 990-T		
5. Did the organization meet any of the exceptions or exclusions to UBI? a. If yes, what are the exceptions? Select one:		
6. Did the organization meet any of the modifications or special rules for computing Unrelated Business Taxable Income (UBTI) a. If yes, what are the modifications? Select one:		
7. Did organization have more than one UBI activity? a. If yes, for years beginning after 12/31/2017, refer to Leadsheet 512(a)(6), UBIT Siloing.		
8. Did organization receive income from partnerships conducting UBI activities? a. If yes, did the income reported on the Form 990-T reconcile to the books and records and information returns the partnerships issued to the organization?		
9. Allocate expenses. Refer to Income and Expense Allocation / Tax Computation Lead Sheet.		
10. Calculate UBTI and UBIT. Refer to Income and Expense Allocation / Tax Computation Lead Sheet.		



## Sources of Unrelated Business Income (UBI) Lead Sheet

Comments:

**Additional Items to Consider:** IRM 4.70.11, Administrative Matters;  
IRM 4.70.13, Executing the Examination;  
IRC 511-513

## E. UBI Income and Expense Allocation Lead Sheet

<b>Income and Expense Allocation / Tax Computation Lead Sheet</b>				
Tax Period	Per Return	Per Audit	Adjustment	WP Reference
<b>Conclusion:</b> <i>(Reflects the final determination on the organization.)</i>				
<p><i>The following techniques aren't intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each organization.</i></p> <p>Reference: IRCs 511 – 515</p>				
<b>Guidelines</b>				
<b>Key Items:</b>			<b>Yes/ No/ NA</b>	<b>WP Ref</b>
1. Did the organization have activities involving dual use of assets? a. If yes, what are the activities and assets:				
2. Did the organization use a reasonable method to allocate income between exempt and UBI activities? a. If no, what are the allocation issues:				
3. What method did the organization use to allocate income?				
4. Did the organization use a reasonable method to allocate expenses between exempt and UBI activities? a. If no, what are the allocation issues:				
5. What method did the organization use to allocate expenses?				
6. Did the organization pay the correct Unrelated Business Income Tax (UBIT)? a. If no, explain:				
7. Did the organization pay taxes to a foreign country or United States possession? a. If yes, did the organization take a credit against the UBIT?				
Comments:				
<b>Additional Items to Consider:</b>				

## F. Advertising Lead Sheet

Advertising Lead Sheet				
Tax Period	Per Return	Per Exam	Adjustment	Reference
<b>Conclusion:</b> <i>(Reflects the final determination on the issue.)</i>				
<p><i>The following techniques aren't intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.</i></p> <p>Reference: <a href="#">IRM 4.70.11</a>, <i>Administrative Matters</i> and <a href="#">IRM 4.70.13</a>, <i>Executing the Examination</i>.</p>				
<b>Audit Steps:</b> <i>(Document audit steps taken or to be taken.)</i>				<b>Workpaper Reference</b>
1. Review Form 990-T, Schedule J, to see if the organization self-identified advertising income				
2. Examine revenue accounts for advertising income				
3. Analyze general ledger revenues and expenses related to advertising or publications				
4. Review publications, newsletters, pamphlets, brochures, magazines, annual reports, website, etc., and determine whether these items further the exempt purpose of the organization or contain advertising or sponsorship				
5. Identify issues arising from the review to determine if there is additional supporting documentation, for example, advertisement pricing charts or contracts				
6. Identify and isolate the organization's unrelated activities				
7. Determine if the activity meets UBI general rules, terms, and modifications in IRC 512. Consider exceptions and special rules in IRC 513				
8. Determine if the sale of advertising exploits an exempt activity; Treas. Reg. 1.512(a)-1(d)				
9. Determine if the conduct of advertising in an exempt organization's journal or other publication is substantially related to the organization's exempt purpose. Apply the rationale of <i>U.S. v. American College of Physicians</i> , 475 U.S. 834 (1986)				
10. Calculate periodical income; Treas. Reg. 1.512(a)-1(f)(3)				
a. Gross advertising income				
b. Circulation Income				

## Advertising Lead Sheet

11. Calculate membership receipts attributable to circulation income of the periodical by allocating membership receipts in accordance with the methods in Treas. Reg. 1.512(a)-1(f)(4)	
12. Calculate periodical costs; Treas. Reg. 1.512(a)-1(f)(6) a. Direct advertising costs, including mechanical and distribution b. Readership costs	
13. Identify the expense allocation method used by the organization: a. Reasonable method b. Gross-to-gross c. Lineage Method d. Consistently applied	
14. Compute UBTI attributable to sale of advertising; Treas. Reg. 1.512(a)-1(f)(2) a. If gross advertising income is more than direct advertising cost, then UBTI is the excess advertising income, reduced (but not below zero) by the excess, if any of readership costs over circulation income b. If gross advertising income is equal to or less than direct advertising costs, then advertising UBTI is zero. Circulation income and readership costs are disregarded. Net operating losses can be carried over within the advertising business silo (if a trade or business).	
15. If there is an advertising loss, then consider: a. Was a reasonable method used? b. Was there a profit motive? c. Was there a NOL? Commissioner v. Groetzinger, 480 U.S. 23 (1987) and Portland Golf Club v. Commissioner, 497 U.S. 154, 171 (1990)	
<b>Facts:</b> <i>(Document the relevant facts.)</i>	
<b>Law:</b> <i>(Tax Law, Regulations, court cases, and other authorities.)</i>	
IRC Sections: 511, 512, 513, Treas. Reg. 1.512(a)-1	
Specific citations:	
<b>Taxpayer Position:</b> <i>(If applicable)</i>	

## G. Debt-Financed Income Lead Sheet

Debt-financed Income Lead Sheet				
Tax Period	Per Return	Per Exam	Adjustment	Reference
<b>Conclusion:</b> (Reflects the final determination on the issue.)				
<p><i>The following techniques aren't intended to be all-inclusive nor are they mandatory steps to be followed. Judgment should be used in selecting the techniques that apply to each taxpayer.</i></p>				
Audit Steps: (Document audit steps taken or to be taken.)				Workpaper Reference
1. Identify income producing properties.				
2. Determine if income producing properties are subject to acquisition indebtedness and are subject to debt-financed income (DFI) rules.				
3. Determine properties' uses. Do the properties further the organization's exempt purpose, or used for unrelated business activities (UBI), or other?				
4. Apply special use rule exceptions: related (substantially, 85%), UBI, research, medical clinic, life income contracts, etc.				
5. Apply neighborhood land exceptions (including church exceptions)				
6. Compute gross income for each unrelated DFI property.				
7. Calculate acquisition indebtedness, property basis, average adjusted basis, average acquisition indebtedness, and debt/basis percentage for each unrelated DFI property. Apply the debt/basis percentage to determine DFI income.				
8. Calculate deductions directly connected with or allocable to DFI for each unrelated DFI property. Apply the debt/basis percentage to determine allowable expenses. (Note: only straight-line depreciation is allowed).				
9. Review allocation method for dual-use properties to ensure the method is reasonable.				
10. Calculate the gain or loss from sale or disposition for each unrelated DFI property.				
11. Compute unrelated DFI taxable income.				
12. Compute unrelated DFI income tax.				

13. Calculate the Net Operating Loss for each unrelated DFI property.	
<b>Facts:</b> (Document the relevant facts.)	
<b>Law:</b> (Tax Law, Regulations, court cases, and other authorities.)	
IRC Sections: 501, 514; Treas. Regs. 1.514(a)-1, 1.514(b)-1, 1.514(c)-1	
Specific citations:	
<b>Taxpayer Position:</b> <i>(If applicable)</i>	