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Tax on Unrelated Business Income of Exempt Organizations

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Contents

Important Changes

Dues received by agricultural and horticultural organizations. Generally, for years beginning after 1986, annual membership dues of not more than $100 (indexed for inflation) received by a tax-exempt agricultural or horticultural organization are exempt from the tax on unrelated business income. The $100 amount increased to $106 for 1997 and $109 for 1998. See *Dues of Agricultural Organizations and Business Leagues* in chapter 4.

Income from controlled foreign corporations. For tax years beginning after 1995, a tax-exempt organization that is a shareholder of a controlled foreign corporation can no longer exclude from unrelated business income, income from certain insurance activities of the controlled foreign corporation. See *Dividends, interest, and annuities* under *Gross Income — Exclusions* in chapter 4.

Income from controlled corporations. For tax years beginning after August 5, 1997, the method for determining how much of a controlled organization's payments of interest, rents, annuities, or royalties is unrelated business taxable income is modified. In addition, the threshold for determining whether an organization is controlled is reduced from 80% to 50% ownership and takes constructive ownership into account. See *Special Rules for Income or Losses From Partnerships and Certain Other Sources* under *Modifications* in chapter 4.

S corporation income or loss. Beginning in 1998, tax-exempt section 501(c)(3) organizations and most qualified retirement plan trusts may own stock in an S corporation without causing the corporation to lose its subchapter S status. An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, and losses in figuring unrelated business taxable income, regardless of the

source or nature of the income, deductions, or losses. See *S corporation income or loss* under *Special Rules for Income or Losses From Partnerships and Certain Other Sources* in chapter 4.

Qualified sponsorship activities. Beginning in 1998, soliciting and receiving qualified sponsorship payments is not an unrelated trade or business and the payments are not subject to unrelated business income tax. See *Excluded Trade or Business Activities* in chapter 3.

Introduction

An exempt organization is not taxed on its income from an activity that is substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. Such income is exempt even if the activity is a trade or business.

However, if an exempt organization regularly carries on a trade or business that is not substantially related to its exempt purpose, except that it provides funds to carry out that purpose, the organization is subject to tax on its income from the unrelated trade or business.

This publication covers the rules for the tax on unrelated business income of exempt organizations. It explains:

1) Which organizations are subject to the tax (chapter 1),

2) What the requirements are for filing a tax return (chapter 2),

3) What is an unrelated trade or business (chapter 3),

4) How to figure unrelated business income (chapter 4), and

5) Important terms such as:

   a) Debt-financed property (chapter 5),

   b) Acquisition indebtedness (chapter 6), and

   c) Unrelated debt-financed income. (chapter 7)

All section references in this publication are to the Internal Revenue Code.

Useful Items

You may want to see:

Publications

☐ **557** Tax-Exempt Status for Your Organization

Forms (and Instructions)

☐ **990–T** Exempt Organization Business Income Tax Return

See chapter 8 for information about getting these publications and forms.

1. Organizations Subject to the Tax

The tax on unrelated business income applies to all organizations exempt from tax under section 501(a) **except** certain ***U.S. instrumentalities*** described in section 501(c)(1).

In addition to the tax-exempt organizations specifically described in section 501(c) (other than section 501(c)(1) corporations), the following are subject to the tax on unrelated business income:

- Tax-exempt employees' trusts forming part of pension, profit-sharing, and stock bonus plans described in section 401(a),
- Individual retirement accounts (IRAs) described in section 408,
- State and municipal colleges and universities,
- Qualified state tuition programs described in section 529, and
- Education individual retirement accounts described in section 530.

U.S. instrumentalities. If a corporation is a U.S. instrumentality, it is not subject to the tax on unrelated business income discussed in this publication. This type of corporation is one that is organized under an Act of Congress, is an instrumentality of the United States and, under the Act, is exempt from federal income taxes. These organizations are exempt from federal income tax under section 501(c)(1).

Colleges and universities. Colleges and universities that are agencies or instrumentalities of any government or any political subdivision of a government, or that are owned or operated by a government or political subdivision of a government, are subject to the tax on unrelated business income. As used here, the word ***government*** includes any foreign government (to the extent not contrary to a treaty) and all domestic governments (the United States and any of its possessions, any state, and the District of Columbia).

The tax is on the unrelated business income of both the universities and colleges themselves and on their wholly owned subsidiary organizations that are tax exempt. It is immaterial whether the business is conducted by the university or by a separately incorporated wholly owned subsidiary. If the business activity is unrelated, the income in both instances will be subject to the tax. If the primary purpose of a wholly owned subsidiary is to operate or carry on any unrelated trade or business (other than holding title to property and collecting income from it), the subsidiary is not an exempt organization and this rule does not apply.

Title-holding corporations. When an exempt title-holding corporation, described in section 501(c)(2), pays any of its net income to an organization that itself is exempt from tax under section 501(a) (or would pay such an amount except that the expenses of collecting its income exceed the amount collected) and files a consolidated return with that organization, the title-holding corporation is treated, for unrelated business income tax purposes, as organized and operated for the same purposes as the exempt payee organization.

Thus, a title-holding corporation, whose source of income is related to the exempt purposes of the payee organization, is not subject to the unrelated business income tax if the holding corporation and the payee organization file a consolidated return. However, if the source of the income is not so related, the title-holding corporation is subject to unrelated business income tax.

Example. X, a title-holding corporation, is required to distribute its net income to A, an exempt organization. During the tax year, X realizes net income of $900,000 from source M, which is related to A's exempt function. X also receives $100,000 from source N, which is not related to A's exempt function. X and A file a consolidated return for the tax year. X has unrelated business income of $100,000.

2. The Tax and Filing Requirements

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. 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.

Alternative minimum tax. Organizations liable for tax on unrelated business income may be liable for alternative minimum tax on certain adjustments and tax preference items.

Returns and Filing Requirements

An exempt organization subject to the tax on unrelated business income must file **Form 990–T**, *Exempt Organization Business Income Tax Return*, and attach any required supporting schedules and forms. The obligation to file Form 990–T is in addition to the obligation to file any other required returns.

Form 990–T is required only if the organization's gross income from unrelated businesses is $1,000 or more. An exempt organization must report income from all its

unrelated businesses on a single Form 990–T. 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.

The various provisions of tax law relating to accounting periods, accounting methods, at-risk limits (described in section 465), assessments, and collection penalties that apply to tax returns generally also apply to Form 990–T.

Where to file. Form 990–T must be filed with the Internal Revenue Service, Ogden, UT 84201–0027.

When to file. The Form 990–T of an organization exempt from tax under section 501(a) (other than an employee's trust described in section 401(a) or an IRA) must be filed by the 15th day of the 5th month after the tax year ends. An employees' trust or an IRA must file Form 990–T by the 15th day of the 4th month after its tax year ends. If the due date falls on a Saturday, Sunday, or legal holiday, the return is due by the next business day.

Extension of time to file. A corporation may request an automatic 6–month extension of time to file a return by submitting Form 7004, *Application for Automatic Extension of Time To File Corporation Income Tax Returns*.

A trust may request an extension of time to file a return by submitting Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information, and Other Returns.* Trusts are not granted automatic extensions of time to file.

Public inspection of return. Unlike information returns filed by exempt organizations Form 990–T is not available for public inspection.

Payment of Tax

Estimated tax. A tax-exempt organization or trust must make estimated tax payments if it expects its tax (unrelated business income tax after certain adjustments) to be $500 or more. Estimated tax payments are generally due by the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. If any due date falls on a Saturday, Sunday, or legal holiday, the payment is due on the next business day.

Any organization that fails to pay the proper estimated tax when due may be charged an underpayment penalty for the period of underpayment. Generally, to avoid the estimated tax penalty, the organization must make estimated tax payments that total 100% of the organization's current tax year liability. However, an organization can base its required estimated tax payments on 100% of the tax shown on its return for the preceding year (unless no tax is shown) if its taxable income for each of the 3 preceding tax years was less than $1 million. If an organization's taxable income for any of those years was $1 million or more, it can base only its first required installment payment on its last year's tax.

All tax-exempt organizations should use Form 990-W (Worksheet), *Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations,* to figure their estimated tax.

Tax due with Form 990–T. 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).

Tax Deposit Methods

An exempt organization must deposit its unrelated business income tax (including estimated tax) using one of the following methods.

Electronic deposits. Some organizations are required to electronically deposit all depository taxes under section 6302, including the unrelated business income tax, using the Electronic Federal Tax Payment System (EFTPS). If the organization is required to deposit electronically and does not do so, it may be subject to a 10% penalty. Organizations that are not required to make electronic deposits may voluntarily participate in EFTPS. For EFTPS information, call 1–800–945–8400 or 1–800–555–4477.

An organization must make electronic deposits if any of the following rules apply.

Tax liabilities occurring after June 1997 and before 1998. An organization must make electronic deposits for these tax liabilities if it:

- Was required to electronically deposit taxes in prior years, or
- Deposited more than $50,000 in social security, Medicare, or withheld income taxes in 1995.

Tax liabilities occurring in 1998. An organization must make electronic deposits for these tax liabilities if it:

- Was required to electronically deposit taxes in prior years,
- Deposited more than $50,000 in social security, Medicare, or withheld income taxes in 1996, or
- Did not deposit social security, Medicare, or withheld income taxes in 1995 or 1996 but deposited more than $50,000 in other depository taxes in either year.

Tax liabilities occurring after 1998. An organization must make electronic deposits for these tax liabilities if it:

- Was required to electronically deposit taxes in prior years,
- Deposited more than $50,000 in social security, Medicare, or withheld income taxes in 1997,
- Did not deposit social security, Medicare, or withheld income taxes in 1997 but deposited more than $50,000 in other depository taxes in that year.

Deposits with Form 8109. If the organization is not required to (or does not voluntarily) make electronic deposits, it must make its deposits with Form 8109, *Federal Tax Deposit (FTD) Coupon.* The completed Form 8109 with the payment must be mailed or delivered to a qualified depositary for federal taxes or Federal Reserve Bank (FRB), as instructed on the coupon. Deposits should not be sent directly to the IRS. A penalty may be imposed if the deposits are sent to an IRS office rather than to an authorized depositary or FRB.

Tax Credits

General business credit. The organization should use Form 3800, *General Business Credit,* to figure its combined credit if it can claim more than one of the general business credits, such as the investment tax credit and the alcohol fuel credit. It should use the separate form for the specific credit if it claims only one of the general business credits. See the instructions for line 39c of Form 990–T.

Foreign tax credit and other credits. For purposes of the foreign tax credit and the possessions corporation tax credit, taxable income is unrelated business taxable income. To take the foreign tax credit, corporations file Form 1118, *Foreign Tax Credit — Corporations,* and trusts file Form 1116, *Foreign Tax Credit.* To take the possessions tax credit, corporations file Form 5735, *Possessions Corporation Tax Credit.*

Other credits available to exempt organizations are explained in the instructions for Form 990–T.

3. Unrelated Trade or Business

Unrelated business income is the income from a ***trade or business*** that is ***regularly carried on*** by an exempt organization and that is ***not substantially related*** to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity.

Certain trade or business activities are not treated as an unrelated trade or business. See *Excluded Trade or Business Activities*, later.

Trade or business. The term “trade or business” generally includes any activity carried on for the production of income from selling goods or performing services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may, or may not be related to the exempt purposes of the organization.

For example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose. Similarly, soliciting, selling, and publishing commercial advertising is a trade or business even though the advertising is published in an exempt organization's periodical that contains editorial matter related to the organization's exempt purpose.

Regularly carried on. Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

For example, a hospital auxiliary's operation of a sandwich stand for 2 weeks at a state fair would not be the regular conduct of a trade or business. The stand would not compete with similar facilities that a nonexempt organization would ordinarily operate year-round. However, operating a commercial parking lot every Saturday, year-round, would be the regular conduct of a trade or business.

Not substantially related. A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds). Whether an activity contributes importantly depends in each case on the facts involved.

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. For example, to the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. The part of the activity that is more than needed to accomplish the exempt purpose is an unrelated trade or business.

Examples

Sales commissions. An agricultural organization, whose exempt purposes are to promote better conditions for cattle breeders and to improve the breed generally, engages in an unrelated trade or business when it regularly sells cattle for its members on a commission basis.

Artists' facilities. An organization whose exempt purpose is to stimulate and foster public interest in the fine arts by promoting art exhibits, sponsoring cultural events, and furnishing information about fine arts leases studio apartments to artist tenants and operates a dining hall primarily for these tenants. These two activities do not contribute importantly to accomplishing the organization's exempt purpose. Therefore, they are unrelated trades or businesses.

Membership list sales. An exempt educational organization regularly sells membership mailing lists to business firms. This activity does not contribute importantly to the accomplishment of the organization's exempt purpose and therefore is an unrelated trade or business. Also see *Exchange or rental of member lists* under *Excluded Trade or Business Activities*, later.

Hospital facilities. An exempt hospital leases its adjacent office building and furnishes certain office services to a hospital-based medical group for a fee. The group provides all diagnostic and therapeutic procedures to the hospital's patients and operates the hospital's emergency room on a 24-hour basis. The leasing activity is substantially related to the hospital's exempt purpose and is not an unrelated trade or business.

The hospital also operates a gift shop patronized by patients, visitors making purchases for patients, and employees; a cafeteria and coffee shop primarily for employees and medical staff; and a parking lot for patients and visitors only. These activities are also substantially related to the hospital's exempt purpose and do not constitute unrelated trades or businesses.

Book publishing. An exempt organization engages primarily in activities that further its exempt purposes. It also owns the publication rights to a book that does not relate to any of its exempt purposes. The organization exploits the book in a commercial manner by arranging for printing, distribution, publicity, and advertising in connection with the sale of the book. These activities constitute a trade or business regularly carried on. Because exploiting the book is unrelated to the organization's exempt purposes (except for the use of the book's profits), the income is unrelated business income. However, if the organization transfers publication rights to a commercial publisher in return for royalties, the royalty income received will not be unrelated business income.

See *Royalties* under *Modifications* in chapter 4.

School handicraft shop. An exempt vocational school operates a handicraft shop that sells articles made by students in their regular courses of instruction. The students are paid a percentage of the sales price. In addition, the shop sells products made by local residents who make articles at home according to the shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that they meet desired standards of style and quality. Although many local participants are former students of the school, any qualified person may participate in the program. The sale of articles made by students does not constitute an unrelated trade or business, but the sale of products made by local residents is an unrelated trade or business and is subject to unrelated business income tax.

School facilities. An exempt school has tennis courts and dressing rooms that it uses during the regular school year in its educational program. During the summer, the school operates a tennis club open to the general public. Employees of the school run the club, including collecting membership fees and scheduling court time.

Another exempt school leases the same type of facilities to an unrelated individual who runs a tennis club for the summer. The lease is for a fixed fee that does not depend on the income or profits derived from the leased property.

In both situations, the exempt purpose is the advancement of education. Furnishing tennis facilities in the manner described does not further that exempt purpose. These activities are unrelated trades or businesses. However, in the second situation the income derived from the leasing of the property is ***excluded*** from unrelated business taxable income as rent from real property. (See *Rents,* under *Modifications* in chapter 4.)

Services provided with lease. An exempt university leases its football stadium during several months of the year to a professional football team for a fixed fee. Under the lease agreement, the university furnishes heat, light, and water and is responsible for all ground maintenance. It also provides dressing room, linen, and stadium security services for the professional team.

Leasing of the stadium is an unrelated trade or business. In addition, the substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental of space for occupancy only. Therefore, the income from this lease is ***not*** excluded from unrelated business taxable income as rent from real property.

Broadcasting rights. An exempt collegiate athletic conference conducts an annual competitive athletic game between its conference champion and another collegiate team. Income is derived from admission charges and the sale of exclusive broadcasting rights to a national radio and television network. An athletic program is considered an integral part of the educational process of a university.

The educational purposes served by intercollegiate athletics are identical whether conducted directly by individual universities or by their regional athletic conference. Also, the educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the broadcasting rights contributes importantly to the accomplishment of the organization's exempt purpose and is not an unrelated trade or business.

In a similar situation, an exempt organization was created as a national governing body for amateur athletes to foster interest in amateur sports and to encourage widespread public participation. The organization receives income each year from the sale of exclusive broadcasting rights to an independent producer, who contracts with a commercial network to broadcast many of the athletic events sponsored, supervised, and regulated by the organization.

The broadcasting of these events promotes the various amateur sports, fosters widespread public interest in the benefits of the organization's nationwide amateur program, and encourages public participation. The sale of the rights and the broadcasting of the events contribute importantly to the organization's exempt purpose. Therefore, the sale of the exclusive broadcasting rights is not an unrelated trade or business.

Yearbook advertising. An exempt organization receives income from the sale of advertising in its annual yearbook. The organization hires an independent commercial firm, under a contract covering a full calendar year, to conduct an intensive advertising solicitation campaign in the organization's name. This firm is paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook. This advertising activity is an unrelated trade or business.

Pet boarding and grooming services. An exempt organization, organized and operated for the prevention of cruelty to animals, receives unrelated business income from providing pet boarding and grooming services for the general public. These activities do not

contribute importantly to its purpose of preventing cruelty to animals.

Museum eating facilities. An exempt art museum operates a dining room, a cafeteria, and a snack bar for use by the museum staff, employees, and visitors. Eating facilities in the museum help to attract visitors and allow them to spend more time viewing the museum's exhibits without having to seek outside restaurants at mealtime. The eating facilities also allow the museum staff and employees to remain in the museum throughout the day. Thus, the museum's operation of the eating facilities contributes importantly to the accomplishment of its exempt purposes and is not unrelated trade or business.

Halfway house workshop. A halfway house organized to provide room, board, therapy, and counseling for persons discharged from alcoholic treatment centers also operates a furniture shop to provide full-time employment for its residents. The profits are applied to the operating costs of the halfway house. The income from this venture is not unrelated trade or business income because the furniture shop contributes importantly to the organization's purpose of aiding its residents' transition from treatment to a normal and productive life.

Travel tour programs. A tax-exempt university alumni association provides a travel tour program for its members and their families. The organization works with various travel agencies and schedules approximately ten tours a year to various places around the world. It mails out promotional material and accepts reservations for a fee paid by the travel agencies on a per-person basis.

The organization provides an employee for each tour as a tour leader. There is no formal educational program conducted with these tours, and they do not differ from regular commercially operated tours.

By providing travel tours to its members, the organization is engaging in a regularly carried on trade or business. Even if the tours it offers support the university, financially and otherwise, and encourage alumni to do the same, they do not contribute importantly to the organization's exempt purpose of promoting education. Therefore, the sale of the travel tours is an unrelated trade or business.

Insurance programs. An organization that acts as a group insurance policyholder for its members and collects a fee for performing administrative services is normally carrying on an unrelated trade or business.

Exceptions. Organizations whose exempt activities may include the provision of insurance benefits, such as fraternal beneficiary societies, voluntary employees beneficiary associations, and labor organizations, are generally exceptions to this rule.

Magazine publishing. An association of credit unions with tax-exempt status as a business league publishes a consumer-oriented magazine four times a year and makes it available to member credit unions for purchase.

By selling a magazine to its members as a promotional device, the organization furnishes its members with a regular commercial service they can use in their own operations. This service does not promote the improvement of business conditions of one or more lines of business, which is the exempt purpose of a business league.

Since the activity does not contribute importantly to the organization's exempt function, it is an unrelated trade or business.

Directory of members. A business league publishes an annual directory that contains a list of all its members, their addresses, and their area of expertise. Each member has the same amount of space in the directory and its format does not emphasize the relative importance or reputation of any member. The directory contains no commercial advertisement and is sold only to the organization's members.

The directory facilitates communication among the members and encourages the exchange of ideas and expertise. Because the directory lists the members in a similar noncommercial format without advertising and is not distributed to the public, its sale does not confer private commercial benefits on the members. The sale of the directory does contribute importantly to the organization's exempt purpose and is not an unrelated trade or business. This directory differs from the publication discussed next because of its noncommercial characteristics.

Sales of advertising space. A national association of law enforcement officials publishes a monthly journal that contains articles and other editorial material of professional interest to its members. The journal is distributed without charge, mainly to the organization's members.

The organization sells advertising space in the journal either for conventional advertising or to merely identify the purchaser without a commercial message. Some of the noncommercial advertising identifies the purchaser in a separate space, and some consists of listings of 60 or more purchasers per page. A business firm identified in a separate space is further identified in an Index of Advertisers.

The organization solicits advertising by personal contacts. Advertising from large firms is solicited by contacting their chief executive officer or community relations officer rather than their advertising manager. The organization also solicits advertising in form letters appealing for corporate and personal contributions.

An exempt organization's sale of advertising placed for the purchaser's commercial benefit is a commercial activity. Goodwill derived by the purchaser from being identified as a patron of the organization is usually considered a form of commercial benefit. Therefore, advertising in an exempt organization's publication is generally presumed to be placed for the purchaser's commercial benefit, even if it has no commercial message. However, this presumption is not conclusive if the purchaser's patronage would be difficult to justify commercially in view of the facts and circumstances. In that case, other factors should also be considered in determining whether a commercial benefit can be expected. Those other factors include:

1) The normal manner in which the publication is circulated,
2) The territorial scope of the circulation,
3) The extent to which its readers, promoters, or the like could reasonably be expected to further, either directly or indirectly, the commercial interest of the advertisers,
4) The eligibility of the publishing organization to receive tax-deductible contributions, and
5) The commercial or noncommercial methods used to solicit the advertisers.

In this situation, the purchaser of a separate advertising space without a commercial message can nevertheless expect a commercial benefit from the goodwill derived from being identified in that manner as a patron of the organization. However, the purchaser of a listing cannot expect more than an inconsequential benefit. Therefore, the sale of separate spaces, but not the listings, is an unrelated trade or business.

Publishing legal notices. A bar association publishes a legal journal containing opinions of the county court, articles of professional interest to lawyers, advertisements for products and services used by the legal profession, and legal notices. The legal notices are published to satisfy state laws requiring publication of notices in connection with legal proceedings, such as the administration of estates and actions to quiet title to real property. The state designated the bar association's journal as the place to publish the required notices.

The publication of ordinary commercial advertising does not advance the exempt purposes of the association even when published in a periodical that contains material related to exempt purposes. Although the advertising is directed specifically to members of the legal profession, it is still commercial in nature and does not contribute importantly to the exempt purposes of the association. Therefore, the advertising income is unrelated trade or business income.

On the other hand, the publication of legal notices is distinguishable from ordinary commercial advertising in that its purpose is to inform the general public of significant legal events rather than to stimulate demand for the products or services of an advertiser. This promotes the common interests of the legal profession and contributes importantly to the association's exempt purposes. Therefore, the publishing of legal notices does not constitute an unrelated trade or business.

Museum greeting card sales. An art museum that exhibits modern art sells greeting cards that display printed reproductions of selected works from other art collections. Each card is imprinted with the name of the artist, the title or subject matter of the work, the date or period of its creation, if known, and the museum's name. The cards contain appropriate greetings and are personalized on request.

The organization sells the cards in the shop it operates in the museum and sells them at quantity discounts to retail stores. It also sells them by mail order through a catalog that is advertised in magazines and other publications throughout the year. As a result, a large number of cards are sold at a significant profit.

The museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards with printed reproductions of artworks contributes importantly to the achievement of the museum's exempt educational purposes by

enhancing public awareness, interest, and appreciation of art. The cards may encourage more people to visit the museum itself to share in its educational programs. The fact that the cards are promoted and sold in a commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact that the activity is related to the museum's exempt purpose. Therefore, these sales activities are not an unrelated trade or business.

Museum shop. An art museum maintained and operated for the exhibition of American folk art operates a shop in the museum that sells:

1) ***Reproductions*** of works in the museum's own collection and reproductions of artistic works from the collections of other art museums (prints suitable for framing, postcards, greeting cards, and slides);
2) Metal, wood, and ceramic ***copies*** of American folk art objects from its own collection and similar copies of art objects from other collections of artworks;
3) Instructional ***literature*** and scientific books and souvenir items concerning the history and development of art and, in particular, of American folk art; and
4) ***Scientific books and souvenir items*** of the city in which the museum is located.

The shop also rents originals or reproductions of paintings contained in its collection. All of its reproductions are imprinted with the name of the artist, the title or subject matter of the work from which it is reproduced, and the museum's name. Each line of merchandise must be considered separately to determine if sales are related to the exempt purpose. The sale and rental of ***reproductions and copies*** of works from the museum's own collection and reproductions of artistic works not owned by the museum 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. The same is true for the sale of ***literature*** relating to art. Therefore, these sales activities are not an unrelated trade or business.

On the other hand, the sale of ***scientific books and souvenir items*** of the city where the museum is located has no causal relationship to art or to artistic endeavor and, therefore, does not contribute importantly to the accomplishment of the museum's exempt educational purposes. The fact that selling some of these items could, under different circumstances, be held related to the exempt educational purpose of some other exempt educational organization does not change this conclusion. Additionally, the sale of these items does not lose its identity as a trade or business merely because the museum also sells articles which do contribute importantly to the accomplishment of its exempt function. Therefore, these sales are an unrelated trade or business.

Business league's parking and bus services. A business league, whose purpose is to retain and stimulate trade in a downtown area that has inadequate parking facilities, operates a fringe parking lot and shuttle bus service. It also operates, as an insubstantial part of its activities, a park and shop plan.

The fringe parking lot and shuttle bus service operate in a manner that does not favor any individual or group of downtown merchants. The merchants cannot offer free or discount parking or bus fares to their customers.

The park and shop plan allows customers of particular merchants to park free at certain parking lots in the area. Merchants participating in this plan buy parking stamps, which they distribute to their customers to use to pay for parking.

Operating the fringe parking lot and shuttle bus service provides easy and convenient access to the downtown area and, therefore, stimulates and improves business conditions in the downtown area generally. That activity contributes importantly to the organization's accomplishing its exempt purpose and is not an unrelated trade or business.

The park and shop plan encourages customers to use a limited number of participating member merchants in order to obtain free parking. This provides a particular service to individual members of the organization and does not further its exempt purpose. Therefore, operating the park and shop plan is an unrelated trade or business.

Youth residence. An exempt organization, whose purpose is to provide for the welfare of young people, rents rooms primarily to people under age 25. The residence units are operated on, and as a part of, the premises in which the organization carries on the social, recreational, and guidance programs for which it was recognized as exempt. The facilities are under the management and supervision of trained career professionals who provide residents with personal counseling, physical education programs, and group recreational activities. The rentals are not an unrelated trade or business because renting the rooms is substantially related to the organization's exempt purpose.

Health club program. An exempt charitable organization's purpose is to provide for the welfare of young people. The organization conducts charitable activities and maintains facilities that will contribute to the physical, social, mental, and spiritual health of young people at minimum or no cost to them. Nominal annual dues are charged for membership in the organization and use of the facilities.

In addition, the organization organized a health club program that its members could join for an annual fee in addition to the annual dues. The annual fee is comparable to fees charged by similar local commercial health clubs and is sufficiently high to restrict participation in the program to a limited number of members of the community.

The health club program is in addition to the general physical fitness program of the organization. Operating this program does not contribute importantly to the organization's accomplishing its exempt purpose and, therefore, is an unrelated trade or business.

Miniature golf course. An exempt youth welfare organization operates a miniature golf course that is open to the general public. The course, which is managed by salaried employees, is substantially similar to commercial courses. The admission fees charged are comparable to fees of commercial facilities and are designed to return a profit.

The operation of the miniature golf course in a commercial manner does not contribute importantly to the accomplishment of the organization's exempt purpose and, therefore, is an unrelated trade or business.

Sales of hearing aids. Unrelated business income does not include income received from the sale of hearing aids to patients by a tax-exempt hospital whose primary activity is rehabilitation. This activity is an essential part of the hospital's program to test and evaluate patients with hearing deficiencies and contributes importantly to its exempt purpose.

Nonpatient laboratory testing. Unrelated business income does not include income that a tax-exempt teaching hospital receives from nonpatient laboratory testing on specimens needed for the conduct of its teaching activities. However, unrelated business income does include income that a tax-exempt non-teaching hospital receives for performing laboratory testing on referred specimens from private office patients of staff physicians if these services are otherwise available in the community.

Selling of products of exempt functions. Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it is in when the exempt functions are completed. Thus, for an exempt organization engaged in rehabilitating handicapped persons, income from selling articles made by these persons as part of their rehabilitation training is not gross income from the conduct of an unrelated trade or business. This income is from the sale of products whose production contributes importantly to accomplishing the purposes for which exemption is granted — namely, rehabilitation of the handicapped.

However, if a completed product resulting from an exempt function is used or exploited in further business activity beyond what is reasonably appropriate or necessary to dispose of it as is, the resulting gross income would be from the conduct of an unrelated trade or business. Thus, in the case of an experimental dairy herd maintained for scientific purposes by an exempt organization, income from the sale of milk and cream produced in the ordinary course of operation of the project would not be gross income from the conduct of an unrelated trade or business. On the other hand, if the organization uses the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of these products would be from the conduct of an unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

Dual use of assets or facilities. In certain cases, an asset or facility necessary to the conduct of exempt functions also may be used in commercial activities. In such cases, the use of the asset or facility for exempt functions does not, by itself, make the income from the commercial activities gross income from a related trade or business. The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of exempt purposes.

For example, a museum has a theater auditorium designed 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 operates continuously while the museum is open to the public. If the organization decides to operate the theater as a motion picture theater for the public when the museum is closed, the income would be considered unrelated business income.

For information on allocating expenses for the dual use of assets or facilities, see *Deductions for Directly Related Expenses* in chapter 4.

Exploitation of exempt functions. Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. When an organization exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization does not make it gross income from a related trade or business. Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the income is gross income from the conduct of an unrelated trade or business. The following examples illustrate this principle. (For the treatment of expenses attributable to the exploitation of exempt activities, see *Deductions for Directly Related Expenses* in chapter 4.)

Example 1. An exempt scientific organization enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of laboratory equipment to manufacturers. Endorsing laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted to the organization. Accordingly, the income from selling endorsements is gross income from an unrelated trade or business.

Example 2. An exempt university has a regular faculty and a regularly enrolled student body. During the school year, the university 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 also are admitted. The university advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. Although the presentation of the performances makes use of an intangible generated by the university's exempt educational functions—the presence of the student body and faculty—such drama and music events contribute importantly to the overall educational and cultural functions of the university. Therefore, the income that it receives does not constitute gross income from the conduct of an unrelated trade or business.

Excluded Trade or Business Activities

The following activities are specifically excluded from the definition of unrelated trade or business.

Volunteer workforce. Any trade or business in which substantially all the work is performed for the organization without compensation is not an unrelated trade or business.

Example 1. A retail store operated by an exempt orphanage where unpaid volunteers perform substantially all the work in carrying on the business is not an unrelated trade or business.

Example 2. A volunteer fire company conducts weekly public dances. Holding public dances and charging admission on a regular basis may, given the facts and circumstances of a particular case, be considered an unrelated trade or business. However, because the work at the dances was performed by unpaid volunteers, the income from the dances is not taxable as unrelated business income.

Convenience of members. A trade or business carried on by a 501(c)(3) organization or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees is not an unrelated trade or business. For example, a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing would not be considered an unrelated trade or business.

Qualified sponsorship activities. Beginning in 1998, soliciting and receiving qualified sponsorship payments is not an unrelated trade or business, and the payments are not subject to unrelated business income tax.

Qualified sponsorship payment. This is any payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgment of the business name, logo, or product lines in connection with the organization's activities. “Use or acknowledgment” does not include advertising the sponsor's products or services. The organization's activities include all its activities, whether or not related to its exempt purposes.

For example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event, the payment is a qualified sponsorship payment and is not subject to the unrelated business income tax.

Providing facilities, services, or other privileges (for example, complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) to a sponsor or the sponsor's designees in connection with a sponsorship payment does not affect whether the payment is a qualified sponsorship payment. Instead, providing these goods or services is treated as a separate transaction in determining whether the organization has unrelated business income from the event. Generally, if the services or facilities are not a substantial benefit or if providing them is a related business activity, the payments will not be subject to unrelated business income tax.

Similarly, the sponsor's receipt of a license to use an intangible asset (for example, a trademark, logo, or designation) of the organization is treated as separate from the qualified sponsorship transaction in determining whether the organization has unrelated business taxable income.

If part of a payment would be a qualified sponsorship payment if paid separately, that part is treated as a separate payment. For example, if a sponsorship payment entitles the sponsor to both product advertising and the use or acknowledgment of the sponsor's name or logo by the organization, then unrelated business income tax does not apply to the part of the payment that is more than the fair market value of the product advertising.

Advertising. A payment is not a qualified sponsorship payment if, in return, the organization advertises the sponsor's products or services. For information on the treatment of payments for advertising, see *Special Rules for Advertising Income* in chapter 4.

Advertising includes:

1) Messages containing qualitative or comparative language, price information, or other indications of savings or value,
2) Endorsements, and
3) Inducements to purchase, sell, or use the products or services.

The use of promotional logos or slogans that are an established part of the sponsor's identity is not, by itself, advertising. In addition, mere distribution or display of a sponsor's product by the organization to the public at a sponsored event, whether for free or for remuneration, is considered use or acknowledgment of the product rather than advertising.

Exception for contingent payments. A payment is not a qualified sponsorship payment if its amount is contingent, by contract or otherwise, upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events. However, the fact that a sponsorship payment is contingent upon an event actually taking place or being broadcast does not, by itself, affect whether a payment qualifies.

Exception for periodicals. A payment is not a qualified sponsorship payment if it entitles the payer to the use or acknowledgment of the business name, logo, or product lines in the organization's periodical. For this purpose, a periodical is any regularly scheduled and printed material (for example, a monthly journal) published by or on behalf of the organization. It does not include material that is related to and primarily distributed in connection with a specific event conducted by the organization (for example, a program or brochure distributed at a sponsored event).

The treatment of payments that entitle the payer to the depiction of the payer's name, logo, or products lines in an organization's periodical is determined under the rules that apply to advertising activities. See *Sales of advertising space* under *Examples,* earlier in this chapter. Also see *Special Rules for Advertising Income* in chapter 4.

Exception for conventions and trade shows. A payment is not a qualified sponsorship payment if it is made in connection with any qualified convention or trade show activity. The exclusion of qualified convention or trade show activities from the definition of unrelated trade or business is explained later under *Convention or trade show activity*.

Selling donated merchandise. A trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions, is not an unrelated trade or business. For example, a thrift shop operated by a tax-exempt organization that sells donated clothes and books to the general public, with the proceeds going to the exempt organization, is not an unrelated trade or business.

Employee association sales. The sale of certain items by a local association of employees described in section 501(c)(4), organized before May 17, 1969, is not an unrelated trade or business if the items are sold for the convenience of the association's members at their usual place of employment. This exclusion applies only to the sale of work-related clothes and equipment and items normally sold through vending machines, food dispensing facilities, or by snack bars.

Bingo games. Certain bingo games are not included in the term "unrelated trade or business." To qualify for this exclusion, the bingo game must meet the following requirements.

1) It meets the legal definition of bingo.
2) It is legal where it is played.
3) It is played in a jurisdiction where bingo games are not regularly carried on by for-profit organizations.

Legal definition. For a game to meet the legal definition of bingo, wagers must be placed, winners must be determined, and prizes or other property must be distributed in the presence of all persons placing wagers in that game.

A wagering game that does not meet the legal definition of bingo does not qualify for the exclusion, regardless of its name. For example, "instant bingo," in which a player buys a pre-packaged bingo card with pull-tabs that the player removes to determine if he or she is a winner, does not qualify.

Legal where played. This exclusion applies only if bingo is legal under the laws of the jurisdiction where it is conducted. The fact that a jurisdiction's law that prohibits bingo is rarely enforced or is widely disregarded does not make the conduct of bingo legal for this purpose.

No for-profit games where played. This exclusion applies only if for-profit organizations cannot regularly carry on bingo games in any part of the same jurisdiction. Jurisdiction is normally the entire state; however, in certain situations, local jurisdiction will control.

Example. Tax-exempt organizations X and Y are organized under the laws of state N, which has a law that permits exempt organizations to conduct bingo games. In addition, for-profit organizations are permitted to conduct bingo games in city S, a resort community located in county R. Several for-profit organizations conduct nightly games. Y conducts weekly bingo games in city S, while X conducts weekly games in county R. Since state law confines the for-profit organizations to city S, local jurisdiction controls. Y's bingo games conducted in city S are an unrelated trade or business. However, X's bingo games conducted in county R outside of city S are not an unrelated trade or business.

Gambling activities other than bingo. Any game of chance conducted by an exempt organization in North Dakota is not an unrelated trade or business if conducting the game does not violate any state or local law.

Pole rentals. The term unrelated trade or business does not include qualified pole rentals by a ***mutual or cooperative telephone or electric company*** described in section 501(c)(12). A qualified pole rental is the rental of a pole (or other structure used to support wires) if the pole (or other structure) is used:

1) By the telephone or electric company to support one or more wires that the company uses in providing telephone or electric services to its members, and
2) According to the rental, to support one or more wires (in addition to the wires described in (1)) for use in connection with the transmission by wire of electricity or of telephone or other communications.

For this purpose, the term rental includes any sale of the right to use the pole (or other structure).

Distribution of low cost articles. The term unrelated trade or business does not include activities relating to the distribution of low cost articles incidental to soliciting charitable contributions. This applies to organizations described in section 501 that are eligible to receive charitable contributions.

A distribution is considered incidental to the solicitation of a charitable contribution if:

1) The recipient did not request the distribution,
2) The distribution is made without the express consent of the recipient, and
3) The article is accompanied by a request for a charitable contribution to the organization and a statement that the recipient may keep the low cost article regardless of whether a contribution is made.

An article is considered low cost if the cost of an item (or the aggregate costs if more than one item) distributed to a single recipient in a tax year is not more than $5, indexed annually for inflation. The maximum cost of a low cost article is $6.90 for 1997 and $7.10 for 1998. The cost of an article is the cost to the organization that distributes the item or on whose behalf it is distributed.

Exchange or rental of member lists. The exchange or rental of member or donor lists between organizations described in section 501 that are eligible to receive charitable contributions is not included in the term unrelated trade or business.

Hospital services. The providing of certain services at or below cost by an exempt hospital to other exempt hospitals that have facilities for 100 or fewer inpatients is not an unrelated trade or business. This exclusion applies only to services described in section 501(e)(1)(A).

Public entertainment activity. An unrelated trade or business does not include a ***qualified*** public entertainment activity. A public entertainment activity is one traditionally conducted at a fair or exposition promoting agriculture and education, including any activity whose purpose is designed to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment.

A ***qualified*** public entertainment activity is one conducted by a ***qualifying organization:***

1) In conjunction with an international, national, state, regional, or local fair or exposition,
2) In accordance with state law that permits the activity to be operated or conducted solely by such an organization or by an agency, instrumentality, or political subdivision of the state, or
3) In accordance with state law that permits an organization to be granted a license to conduct an activity for not more than 20 days on paying the state a lower percentage of the revenue from the activity than the state charges nonqualifying organizations that hold similar activities.

For these purposes, a ***qualifying organization*** is an organization described in section 501(c)(3), 501(c)(4), or 501(c)(5) that regularly conducts an agricultural and educational fair or exposition as one of its substantial exempt purposes. Its conducting qualified public entertainment activities will not affect determination of its exempt status.

Convention or trade show activity. Unrelated trade or business income does not include income received from ***qualified*** convention or trade show activities conducted at a convention, annual meeting, or trade show.

A ***qualified*** convention or trade show activity is any activity of a kind traditionally carried on by a ***qualifying organization*** in conjunction with an international, national, state, regional, or local convention, annual meeting, or show if:

1) One of the purposes of the organization in sponsoring the activity is promoting and stimulating interest in, and demand for, the products and services of that industry, or, educating the persons in attendance regarding new products and services or new rules and regulations affecting the industry, and
2) The show is designed to achieve its purpose through the character of the exhibits and the extent of the industry products that are displayed.

For these purposes, a ***qualifying organization*** is one described in section 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(6). The organization must regularly conduct, as one of its substantial exempt purposes, a qualified convention or trade show activity.

The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified convention or trade show will not be considered an unrelated trade or business even though the exhibitors who rent the space are permitted to sell or solicit orders. For this purpose, a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, members of the qualifying organization in the conduct of these members' own trades or businesses.

4.

Unrelated Business Taxable Income

The term ***unrelated business taxable income*** means the gross income derived from any unrelated trade or business regularly carried on by the exempt organization, less the deductions directly connected with carrying on the trade or business, both computed with the modifications discussed in this chapter.

If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to all the activities.

Deductions for Directly Related Expenses

To qualify as allowable deductions in computing unrelated business taxable income, the expenses, depreciation, and similar items must qualify as allowable income tax deductions and also must be directly connected with carrying on an unrelated trade or business.

Directly connected. To be directly connected with the conduct of an unrelated business, deductions must have a proximate and primary relationship to carrying on that business. For an exception, see *Expenses attributable to exploitation of exempt activities*, later.

Expenses attributable solely to unrelated business. Expenses, depreciation, and similar items attributable solely to the conduct of an unrelated business are proximately and primarily related to that business and qualify for deduction to the extent that they are otherwise allowable income tax deductions.

For example, salaries of personnel employed full-time to carry on the unrelated business and depreciation of a building used entirely in the conduct of that business are deductible to the extent otherwise allowable.

Expenses attributable to dual use of facilities or personnel. When facilities or personnel are used both to carry on exempt functions and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis.

The part of an item allocated to the unrelated trade or business is proximately and primarily related to that business, and is allowable as a deduction in computing unrelated business taxable income, if the expense is otherwise an allowable income tax deduction. For example, a school recognized as a tax-exempt organization contracts with an individual to conduct a summer tennis camp. The school provides the tennis courts, housing, and dining facilities. The contracted individual hires the instructors, recruits campers, and provides supervision. The income the school receives from this activity is from a dual use of the facilities and personnel. The school, in computing its unrelated business taxable income, may deduct an allocable part of the expenses attributable to the facilities and personnel.

Allocation method. The allocation method used must require that only expenses associated with profit-motivated activities can be deducted. For example, an exempt organization with gross income from an unrelated trade or business pays its president $90,000 a year. The president devotes approximately 10% of the time to the unrelated business. To figure the unrelated business taxable income, a deduction of $9,000 ($90,000 × 10%) would be allowable for the salary paid to its president.

Expenses attributable to exploitation of exempt activities. Generally, expenses, depreciation, and similar items attributable to the conduct of an exempt activity are not deductible in computing unrelated business taxable income from an unrelated trade or business that exploits the exempt activity because they do not have proximate and primary relationship to the unrelated trade or business. Therefore, they do not qualify as directly connected with that business.

However, these expenses, depreciation, and similar items may be treated as directly connected with the conduct of the unrelated business if all the following statements are true.

1) The unrelated business exploits the exempt activity. (See *Exploitation of exempt functions* under *Examples* in chapter 3.)

2) The unrelated business is a type normally carried on for profit by taxable organizations.

3) The exempt activity is a type normally conducted by taxable organizations in carrying on that type of business.

The amount treated as directly connected is the smaller of:

1) The excess of these expenses, depreciation, and similar items over the income from, or attributable to, the exempt activity, or

2) The gross unrelated business income reduced by all other expenses, depreciation, and other items that are actually directly connected.

For the application of these rules to an advertising activity that exploits an exempt publishing activity, see *Special Rules for Advertising Income*, later.

Dues of Agricultural Organizations and Business Leagues

Dues received from associate members by organizations exempt under section 501(c)(5) or section 501(c)(6) may be treated as gross income from an unrelated trade or business if the associate member category exists for the principal purpose of producing unrelated business income. For example, if an organization creates an associate member category solely to allow associate members to purchase insurance through the organization, the associate member dues may be unrelated business income.

Exception. For tax years beginning after 1986, associate member dues received by an agricultural or horticultural organization are not treated as gross income from an unrelated trade or business, regardless of their purpose, if the annual dues are not more than $100, indexed for inflation. The $100 amount increased to $106 for 1997 and $109 for 1998.

If the required annual dues are more than the limit ($106 for 1997; $109 for 1998), the entire amount is treated as income from an unrelated business unless the associate member category was formed or availed of for the principal purpose of furthering the organization's exempt purposes.

Special Rules for Advertising Income

The sale of advertising in a periodical of an exempt organization that contains editorial material related to the accomplishment of the organization's exempt purpose is an unrelated business that exploits an exempt activity, the circulation and readership of the periodical. Therefore, in addition to direct advertising costs, exempt activity costs (expenses, depreciation, and similar expenses attributable to the production and distribution of the editorial or readership content) can be treated as directly connected with the conduct of the advertising activity. (See *Expenses attributable to exploitation of exempt activities* under *Deductions for Directly Related Expenses*, earlier.)

Figuring unrelated business taxable income (UBTI). The UBTI of an advertising activity is the amount shown in the following chart.

IF gross advertising income is...	THEN UBTI is...
More than direct advertising costs	The excess advertising income, reduced (but not below zero) by the excess, if any, of readership costs over circulation income
Equal to or less than direct advertising costs	Zero • Circulation income and readership costs are not taken into account. • Any excess advertising costs reduce (but not below zero) UBTI from any other unrelated business activity.

The terms used in the chart are explained in the following discussions.

Periodical Income

Gross advertising income. This is all the income from the unrelated advertising activities of an exempt organization periodical.

Circulation income. This is all the income from the production, distribution, or circulation of an exempt organization's periodical (other than gross advertising income). It includes all amounts from the sale or distribution of the readership content of the periodical, such as income from subscriptions. It also includes allocable membership receipts if the right to receive the periodical is associated with a membership or similar status in the organization.

Allocable membership receipts. This is the part of membership receipts (dues, fees, or other charges associated with membership) equal to the amount that would have been charged and paid for the periodical if:

1) The periodical was published by a taxable organization,

2) The periodical was published for profit, and

3) The member was an unrelated party dealing with the taxable organization at arm's length.

The amount used to allocate membership receipts is the amount shown in the following chart.

IF...	THEN the amount used to allocate membership receipts is...
20% or more of the total circulation consists of sales to nonmembers	The subscription price charged nonmembers.
The above condition does not apply, **and** 20% or more of the members pay reduced dues because they do not receive the periodical	The reduction in dues for a member not receiving the periodical.
Neither of the above conditions applies	The membership receipts multiplied by this fraction: $\frac{\text{Total periodical costs}}{\text{Total periodical costs Plus Cost of other exempt activities}}$

For this purpose, the total periodical costs are the sum of the direct advertising costs and the readership costs, explained under *Periodical Costs*, later. The cost of other exempt activities means the total expenses incurred by the organization in connection with its other exempt activities, not offset by any income earned by the organization from those activities.

Example 1. U is an exempt scientific organization with 10,000 members who pay annual dues of $15. One of U's activities is publishing a monthly periodical distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmembers, who subscribe for $10 a year. Since the nonmember circulation of U's periodical represents one-third (more than 20%) of its total circulation, the subscription price charged to nonmembers is used to determine the part of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts are $100,000 ($10 times 10,000 members), and U's total circulation income for the periodical is $150,000 ($100,000 from members plus $50,000 from sales to nonmembers).

Example 2. Assume the same facts except that U sells only 500 copies of its periodical to nonmembers, at a price of $10 a year. Assume also that U's members may elect not to receive the periodical, in which case their dues are reduced from $15 a year to $6 a year, and that only 3,000 members elect to receive the periodical and pay the full dues of $15 a year. U's stated subscription price of $9 to members consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represent only 14% of the 3,500 copies distributed, the $10 subscription price charged to nonmembers is not used to determine the part of membership receipts allocable to the periodical. Instead, since 70% of the members elect not to receive the periodical and pay $9 less per year in dues, the $9 price is used to determine the subscription price charged to members. Thus, the allocable membership receipts will be $9 a member, or $27,000 ($9 times 3,000 copies). U's total circulation income is $32,000 ($27,000 plus the $5,000 from nonmember subscriptions).

Periodical Costs

Direct advertising costs. These are expenses, depreciation, and similar items of deduction directly connected with selling and publishing advertising in the periodical.

Examples of allowable deductions under this classification include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and office overhead directly connected with the sale of advertising lineage in the periodical. Also included are other deductions commonly classified as advertising costs under standard account classifications, such as artwork and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

In addition, direct advertising costs include the part of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includable in mechanical and distribution costs ordinarily employed in business-paper and consumer-publication accounting provide a guide for the computation. Accordingly, the mechanical and distribution costs include the part of the costs and other expenses of composition, press work, binding, mailing (including paper and wrappers used for mailing), and bulk postage attributable to the advertising lineage of the publication.

In the absence of specific and detailed records, the part of mechanical and distribution costs attributable to the periodical's advertising lineage can be based on the ratio of advertising lineage to total lineage in the periodical, if this allocation is reasonable.

Readership costs. These are all expenses, depreciation, and similar items that are directly connected with the production and distribution of the readership content of the periodical.

Costs partly attributable to other activities. Deductions properly attributable to exempt activities other than publishing the periodical may not be allocated to the periodical. When expenses are attributable both to the periodical and to the organization's other activities, an allocation must be made on a reasonable basis. The method of allocation will vary with the nature of the item, but once adopted, should be used consistently. Allocations based on dollar receipts from various exempt activities generally are not reasonable since receipts usually do not accurately reflect the costs associated with specific activities that an exempt organization conducts.

An exempt organization's periodical is published to produce income if:

1) The periodical generates gross advertising income to the organization equal to at least 25% of its readership costs, and

2) Publishing the periodical is an activity engaged in for profit.

Whether the publication of a periodical is an activity engaged in for profit can be determined only by all the facts and circumstances in each case. The facts and circumstances must show that the organization carries on the activity for economic profit, although there may not be a profit in a particular year. For example, if an organization begins publishing a new periodical whose total costs exceed total income in the start-up years because of lack of advertising sales, that does not mean that the organization did not have as its objective an economic profit. The organization may establish that it had this objective by showing it can reasonably expect advertising sales to increase, so that total income will exceed costs within a reasonable time.

Example. Y, an exempt trade association, publishes three periodicals that it distributes to its members: a weekly newsletter, a monthly magazine, and a quarterly journal. Both the monthly magazine and the quarterly journal contain advertising that accounts for gross advertising income equal to more than 25% of their respective readership costs. Similarly, the total income attributable to each periodical has exceeded the total deductions attributable to each periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price is not intended to cover the cost of publication. The newsletter is a service that Y distributes to all of its members in an effort to keep them informed of changes occurring in the business world. It is not engaged in for profit.

Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its unrelated business taxable income. It may not consolidate the income and deductions from the newsletter with the income and deductions of its other periodicals, since the newsletter is not published for the production of income.

Special Rules for Foreign Organizations

The unrelated business taxable income of a foreign organization exempt from tax under section 501(a) consists of the organization's:

1) Unrelated business taxable income derived from sources within the United States, but not effectively connected with the conduct of a trade or business within the United States, plus

2) Unrelated business taxable income effectively connected with the conduct of a trade or business within the United States, whether or not this income is derived from sources within the United States.

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 sections 861 through 864 and the related regulations.

Special Rules for Social Clubs, VEBAs and SUBs

The following discussion applies to:

- ***Social clubs*** described in section 501(c)(7),
- ***Voluntary employees' beneficiary associations (VEBAs)*** described in section 501(c)(9), and
- ***Supplemental unemployment compensation benefit trusts (SUBs)*** described in section 501(c)(17).

These organizations must figure unrelated business taxable income under special rules. Unlike other exempt organizations, they cannot exclude their investment income (dividends, interest, rents, etc.). (See *Gross Income—Exclusions* under *Modifications,* later.) Therefore, they are generally subject to unrelated business income tax on this income.

The unrelated business taxable income of these organizations includes all gross income, less deductions directly connected with the production of that income, except that gross income for this purpose does not include ***exempt function income.*** The dividends received deduction for corporations is not allowed in computing unrelated business taxable income because it is not an expense incurred in the production of income.

The unrelated business taxable income is modified by any net operating loss or charitable contributions deduction and by the specific deduction (described later under *Modifications*.

Exempt function income. This is gross income from dues, fees, charges or similar items paid by members for goods, facilities, or services to the members or their dependents or guests, to further the organization's exempt purposes. Exempt function income also includes ***income that is set aside*** for qualified purposes.

Income that is set aside. This is income ***set aside*** to be used for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. In addition, for a VEBA or SUB, it is income set aside to provide for the payment of life, sick, accident, or other benefits.

However, any amounts set aside by a VEBA or SUB that exceed the organization's qualified asset account limit (determined under section 419A) are unrelated business income. Special rules apply to the treatment of existing reserves for post-retirement medical or life insurance benefits. These rules are explained in section 512(a)(3)(E).

Income derived from an unrelated trade or business ***may not be set aside*** and therefore cannot be exempt function income. In addition, any income set aside and later spent for other purposes must be included in unrelated business taxable income.

Income is generally excluded from gross income only if it is set aside in the tax year in which it is otherwise includible in gross income. However, income set aside on or before the date for filing Form 990–T, including extensions of time, may, at the election of the organization, be treated as having been set aside in the tax year for which the return was filed. The income set aside must have been includible in gross income for that earlier year.

Nonrecognition of gain. If the organization sells property used directly in performing an exempt function and purchases other property used directly in performing an exempt function, any gain on the sale is recognized only to the extent that the sales price of the old property exceeds the cost of the new property. The purchase of the new property must be made within 1 year before the date of sale of the old property or within 3 years after the date of sale.

This rule also applies to gain from an involuntary conversion of the property resulting from its destruction in whole or in part, theft, seizure, requisition, or condemnation.

Special Rules for Veterans' Organizations

Unrelated business taxable income of a veterans' organization that is exempt under section 501(c)(19) does not include the net income from insurance business that is properly set aside. The organization may set aside income from payments received for life, sick, accident, or health insurance for the organization's members or their dependents for the payment of insurance benefits or reasonable costs of insurance administration, or for use exclusively for religious, charitable, scientific, literary, or educational purposes, or the prevention of cruelty to children or animals. For details, see section 512(a)(4) and the regulations under that section.

Modifications

In computing unrelated business taxable income, gross income and deductions are subject to certain modifications and special rules. Whether a particular item of income or expense falls within any of these modifications or special rules must be determined by all the facts and circumstances in each specific case.

For example, if the organization received a payment termed rent that is in fact a return of profits by a person operating the property for the benefit of the organization, or that is a share of the profits retained by the organization as a partner or joint venturer, the payment is not within the modification for rents.

The modifications (to gross income and deductions) and special rules are as follows.

Gross Income — Exclusions

Dividends, interest, and annuities. All dividends, interest, payments with respect to securities loans, annuities, income from notional principal contracts, and other income from an exempt organization's ordinary and routine investments that the IRS determines are substantially similar to these types of income, and deductions directly connected with these types of income, are excluded in computing unrelated business taxable income.

Exception for insurance activity income of a controlled foreign corporation. For tax years beginning after 1995, this exclusion does not apply to income from certain insurance activities of an exempt organization's controlled foreign corporation. The income is not excludable dividend income, but instead is unrelated business taxable income to the extent it would be so treated if the exempt organization had earned it directly. Certain exceptions to this rule apply. For more information, see section 512(b)(17).

Other exceptions. This exclusion does not apply to unrelated debt-financed income (discussed in chapter 7) or to interest or annuities received from a controlled corporation (discussed under *Special Rules for Income or Losses From Partnerships and Certain Other Sources*, later).

Income from lending securities. Payments received with respect to a security loan are excluded in computing unrelated business taxable income if certain requirements are met.

The transfer must be under an agreement that provides for:

1) Return to the transferor of securities identical to the securities transferred,
2) Payments to the transferor of amounts equivalent to all interest, dividends, and other distributions that the owner of the securities is entitled to receive during the period of the loan,
3) Risk of loss or opportunity for gain not to be reduced for the transferor,
4) Reasonable procedures to implement the obligation of the transferee to furnish to the transferor, for each business day during the period of the loan, collateral with a fair market value not less than the fair market value of the security at the close of the preceding business day, and
5) Termination of the loan by the transferor upon notice of not more than 5 business days.

Payments with respect to securities loans include:

1) Amounts in respect of dividends, interest, and other distributions,
2) Fees based on the period of time the loan is in effect and the fair market value of the security during that period,
3) Income from collateral security for the loan, and
4) Income from the investment of collateral security.

The payments with respect to securities loans are considered to be from the securities loaned and not from collateral security or the investment of collateral security from the loans. Any deductions that are directly connected with collateral security for the loan, or with the investment of collateral security, are considered deductions that are directly connected with the securities loaned.

Royalties. Royalties, including overriding royalties, and deductions directly connected with these royalties are excluded in computing unrelated business taxable income.

To be considered a royalty, a payment must relate to the use of a valuable right. Payments for trademarks, trade names, or copyrights are ordinarily considered royalties. Therefore, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily considered royalties. However, royalties do not include payments for personal services. Therefore, payments for personal appearances and interviews are not excluded as royalties and must be included as income from an unrelated trade or business.

Unrelated business taxable income does not include royalty income received from licensees by an exempt organization that is the legal and beneficial owner of patents assigned to it by inventors for specified percentages of future royalties.

Mineral royalties are excluded whether measured by production or by gross or taxable income from the mineral property. However, the exclusion does not apply to royalties that stem from an arrangement whereby the organization owns a working interest in a mineral property and is liable for its share of the development and operating costs under the terms of its agreement with the operator of the property. To the extent they are not treated as loans under section 636 (relating to income tax treatment of mineral production payments), payments for mineral production are treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent they are treated as loans, any payments for production that are the equivalent of interest are treated as interest and are excluded.

Exceptions. This exclusion does not apply to debt-financed income (discussed in chapter 7) or to royalties received from a controlled corporation (discussed under *Special Rules for Income or Losses From Partnerships and Certain Other Sources,* later).

Rents. Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Rents from personal property are not excluded. However, special rules apply to “mixed leases” of both real and personal property.

Deductions directly connected with excluded rents are also excluded in computing unrelated business taxable income.

Mixed leases. In a mixed lease, all of the rents are excluded if the rents attributable to the personal property are not more than 10% of the total rents under the lease, as determined when the personal property is first placed in service by the lessee. If the rents attributable to personal property are more than 10% but not more than 50% of the total rents, only the rents attributable to the real property are excluded. If the rents attributable to the personal property are more than 50% of the total rents, none of the rents are excludable.

Property is placed in service when the lessee first may use it under the terms of a lease. For example, property subject to a lease entered into on November 1, for a term starting on January 1 of the next year, is considered placed in service on January 1, regardless of when the lessee first actually uses it.

If separate leases are entered into for real and personal property and the properties have an integrated use (for example, one or more leases for real property and another lease or leases for personal property to be used on the real property), all the leases will be considered as one lease.

The rent attributable to the personal property must be recomputed, and the treatment of the rents must be redetermined, if:

1) The rent attributable to all the leased personal property increases by 100% or more because additional or substitute personal property is placed in service, or
2) The lease is modified to change the rent charged (whether or not the amount of rented personal property changes).

Any change in the treatment of rents resulting from the recomputation is effective only for the period beginning with the event that caused the recomputation.

Exception for rents based on net profit. The exclusion for rents does not apply if the amount of the rent depends on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage of the gross receipts or sales.

Exception for income from personal services. Payment for occupying space when personal services are also rendered to the occupant does not constitute rent from real property. Therefore, the exclusion does not apply to such transactions as renting hotel rooms, rooms in boarding houses or tourist homes, and space in parking lots or warehouses.

Other exceptions. This exclusion does not apply to unrelated debt-financed income (discussed in chapter 7) or to rents received from a controlled corporation (discussed under *Special Rules for Income or Losses From Partnerships and Certain Other Sources,* later).

Income from research. A tax-exempt organization may exclude income from research grants or contracts from unrelated business taxable income. However, the extent of the exclusion depends on the nature of the organization and the type of research.

Income from research for the United States, any of its agencies or instrumentalities, a state, or any of its political subdivisions, and all deductions connected with this income, are excluded when computing unrelated business taxable income.

For a college, university, or hospital, all income from research, whether fundamental or applied, and all directly connected deductions are excluded in computing unrelated business taxable income.

When an organization is operated primarily to conduct fundamental research (as distinguished from applied research) and the results are freely available to the general public, all income from research performed for any person and all deductions directly connected with the income are excluded in computing unrelated business taxable income.

The term ***research***, for this purpose, does not include activities of a type normally carried on as an incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment, buildings, etc. In addition, the term ***fundamental research*** does not include research carried on for the primary purpose of commercial or industrial application.

Gains and losses from disposition of property. Also excluded from unrelated business taxable income are gains or losses

from the sale, exchange, or other disposition of property other than:

1) Stock in trade or other property of a kind that would properly be includable in inventory if on hand at the close of the tax year,

2) Property held primarily for sale to customers in the ordinary course of a trade or business, or

3) Cutting of timber that an organization has elected to consider as a sale or exchange of the timber.

It should be noted that the last exception relates only to cut timber. The sale, exchange, or other disposition of standing timber is excluded from the computation of unrelated business income, unless it constitutes property held for sale to customers in the ordinary course of business.

Exception. This exclusion does not apply to unrelated debt-financed income. (See chapter 7.)

Lapse or termination of options. Any gain from the lapse or termination of options to buy or sell securities is excluded from unrelated business taxable income. The exclusion applies only if the option is written in connection with the exempt organization's investment activities. Therefore, this exclusion is not available if the organization is engaged in the trade or business of writing options or the options are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business.

Income from services provided under federal license. There is a further exclusion from unrelated business taxable income together with all deductions connected with this income when the trade or business is carried on by a religious order or by an educational organization maintained by the order.

To qualify for this exclusion, it must be shown that:

1) The trade or business has been operated by the order or by the institution since before May 27, 1959,

2) The trade or business consists of providing services under a license issued by a federal regulatory agency,

3) More than 90% of the net income from the business for the tax year is devoted to religious, charitable, or educational purposes that constitute the basis for the religious order's exemption, and

4) It is established to the satisfaction of the IRS that the rates or other charges for these services are fully competitive with rates or other charges for these services by persons not exempt from taxation. Rates or other charges for these services will be considered as fully competitive if the rates charged by the unrelated trade or business are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area. This provision does not apply to debt-financed property.

Deductions

Net operating loss deduction. The net operating loss deduction (as provided in section 172) is allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a tax year for which the organization is subject to tax on unrelated business income) is determined without taking into account any amount of income or deduction that has been excluded specifically in computing unrelated business taxable income. For example, a loss from an unrelated trade or business is not diminished because dividend income was received.

If this were not done, organizations would, in effect, be taxed on their exempt income, since unrelated business losses then would be offset by income from dividends, interest, and other excluded sources of income. This would reduce the loss that could be applied against unrelated business income of prior or future tax years. Therefore, to preserve the immunity of exempt income, all computations of net operating losses are limited to those items of income and deductions that affect the unrelated business taxable income.

In line with this concept, a net operating loss carryback or carryover is allowed only from a tax year for which the organization is subject to tax on unrelated business income.

For example, if an organization just became subject to the tax last year, its net operating loss for that year is not a carryback to a prior year when it had no unrelated business taxable income, nor is its net operating loss carryover to succeeding years reduced by the related income of those prior years.

However, in determining the span of years for which a net operating loss may be carried back or forward, the tax years for which the organization is not subject to the tax on unrelated business income are counted. For example, if an organization is subject to the tax for 1996 and has a net operating loss for that year, the last tax year to which any part of that loss may be carried over is the year 2011, regardless of whether the organization is subject to the unrelated business income tax in any of the intervening years.

Charitable contributions deduction. An organization taxable at corporate rates is allowed a deduction for charitable contributions up to 10% of its unrelated business taxable income computed without regard to the deduction for contributions. Contributions in excess of the 10% limit may be carried over to the next 5 taxable years. A contribution carryover is not allowed, however, to the extent that it increases a net operating loss carryover.

A trust generally is allowed a deduction for charitable contributions in the same amounts as allowed for individuals. However, the limit on the deduction is determined in relation to unrelated business taxable income computed without regard to the deduction, rather than in relation to adjusted gross income.

For purposes of the deduction, a distribution by a trust made under the trust instrument to a beneficiary, which itself is a qualified organization, is treated the same as a contribution.

The deduction, whether made by a trust or other exempt organization, is allowed whether or not the contributions are directly connected with the unrelated business.

To be deductible, the contribution must be paid to another qualified organization. For example, an exempt university that operates an unrelated business may deduct a contribution made to another university for educational work, but may not claim a deduction for contributions of amounts spent for carrying out its own educational program.

An organization (whether a corporation or a trust) may deduct contributions only in the year paid or in the 5 succeeding taxable years. However, an organization on the accrual basis may elect to deduct contributions authorized, but not paid, during the tax year if payment is made within 2½ months after the close of the tax year.

Specific deduction. In computing unrelated business taxable income, a specific deduction of $1,000 is allowed. However, the specific deduction is not allowed in computing a net operating loss or the net operating loss deduction.

Generally, the deduction is limited to $1,000 regardless of the number of unrelated businesses in which the organization is engaged.

Exception. An exception is provided in the case of a diocese, province of a religious order, or a convention or association of churches that may claim a specific deduction for each parish, individual church, district, or other local unit. In these cases, the specific deduction for each local unit is limited to the lower of:

- $1,000, or
- Gross income derived from an unrelated trade or business regularly carried on by the local unit.

This exception applies only to parishes, districts, or other local units that are not separate legal entities, but are components of a larger entity (diocese, province, convention, or association) filing Form 990-T. The parent organization must file a return reporting the unrelated business gross income and related deductions of all units that are not separate legal entities. The local units cannot file separate returns. However, each local unit that is separately incorporated must file its own return and cannot include, or be included with, any other entity. See *Title-holding corporations* in chapter 1 for a discussion of the only situation in which more than one legal entity may be included on the same Form 990–T.

Example. X is an association of churches and is divided into local units A, B, C, and D. Last year, A, B, C, and D derived gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses that they regularly conduct. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, $1,000 with respect to C, and $700 with respect to D.

Special Rules for Income or Losses From Partnerships and Certain Other Sources

Partnership income or loss. An organization may have unrelated business income or loss as a member of a partnership, rather than through direct dealings with a business. If so, it must treat its share of the partnership

income or loss as if it had conducted the business activity in its own capacity as a corporation or trust. No distinction is made between limited and general partners.

Thus, if an organization is a member of a partnership regularly engaged in a trade or business, that is an unrelated trade or business with respect to the organization the organization must include in its unrelated business taxable income its share of the partnership's gross income (whether or not distributed), and the deductions attributable to it, that come from the unrelated trade or business.

The partnership gross income and deductions are figured the same way as any unrelated trade or business income the organization earns directly. For example, an exempt educational organization is a partner in a partnership that operates a factory, and the partnership also holds stock in a corporation. The exempt organization must include its share of the gross income from operating the factory in its unrelated business taxable income, but may exclude its share of any dividends the partnership received from the corporation.

If the exempt organization and the partnership of which it is a member have different tax years, the partnership items that 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 partnership's tax year that ends within or with the organization's tax year.

S corporation income or loss. Beginning in 1998, exempt section 501(c)(3) organizations and qualified retirement plan trusts (other than employee stock ownership plans (ESOPs)) may own stock in an S corporation without causing the corporation to lose its subchapter S status. An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, or losses in figuring unrelated business taxable income, regardless of the actual source or nature of the income, deductions, and losses. For example, the organization's share of the S corporation's interest and dividend income will be taxable, even though interest and dividends are normally excluded from unrelated business taxable income. The organization must also take into account its gain or loss on the sale or other disposition of the S corporation stock in figuring unrelated business taxable income.

Income from controlled organizations (for tax years beginning before August 6, 1997). The following rules apply to tax years beginning before August 6, 1997. They also apply to certain payments made in later tax years under a contract in effect on June 8, 1997, as explained under *Income from controlled organizations (for tax years beginning after August 5, 1997),* later.

The exclusion of interest, annuities, royalties, and rents, as previously discussed, does not apply when an exempt controlling organization receives them from a controlled organization (whether or not the activities producing this income represent a trade or business or are regularly carried on). The interest, annuities, royalties, and rents from the controlled organization are taxable to the controlling organization at a specific ratio depending on whether the controlled organization is exempt or nonexempt. All deductions directly connected with amounts included in an organization's gross income under this provision are allowed.

If control is gained or lost during the tax year, amounts of interest, annuities, royalties, and rents are includible in the controlling organization's unrelated business taxable income only for the part of the tax year it has control.

Control. If the organization from which the interest, annuities, royalties, and rents are received is a stock corporation, control generally means stock ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock in the corporation.

In the case of a nonstock organization, control means that at least 80% of the directors or trustees of the organization are either representatives of, or directly or indirectly controlled by, the controlling organization.

Exempt controlled organization. When the controlled organization is an exempt organization, the interest, annuities, royalties, and rents received by the controlling organization are includible in its unrelated business taxable income in the same ratio as the ratio of the controlled organization's unrelated business taxable income to its taxable income determined as if the exempt controlled organization were not tax exempt. The controlled organization's taxable income determined for this purpose cannot be less than its unrelated business taxable income. Both amounts must be computed without regard to amounts paid directly or indirectly to the controlling organization. The controlling organization will be allowed all deductions directly connected with the amounts included in gross income.

Example. A, an exempt organization, owns all the stock of B, another exempt organization. During the year, A rents a laboratory to B for $15,000 a year. A's total deductions for the year with respect to the leased property are $3,000 ($1,000 for maintenance and $2,000 for depreciation). If B were not an exempt organization, its total taxable income would be $300,000, disregarding rent paid to A. B's unrelated business taxable income, disregarding rent paid to A, is $100,000. Under these circumstances, the amount of rent paid by B that will be included by A as net rental income in determining its unrelated business taxable income is $4,000, computed as follows:

B's unrelated business taxable income (disregarding rent paid to A)	$100,000
B's taxable income (computed as though B were not exempt and disregarding rent paid to A)	$300,000
Ratio ($100,000/$300,000)	1/3
Total rent	$ 15,000
Total deductions	$ 3,000
Rental income treated as gross income from an unrelated trade or business (1/3 of $15,000)	$ 5,000
Less deductions directly connected with that income (1/3 of $3,000)	1,000
Net rental income included by A in computing its unrelated business taxable income	$ 4,000

If B's taxable income, in this example, were less than its unrelated business taxable income, the total rent ($15,000) and deductions directly connected to that rent ($3,000) would be included by A in computing its unrelated business taxable income.

Nonexempt controlled organization. When a controlled organization is not exempt from tax, the amount of interest, annuities, royalties, and rents received by the controlling organization that is includible in its unrelated business taxable income is an amount that bears the same ratio to the interest, annuities, royalties, and rents that the controlling organization received from the controlled organization as the ***excess taxable income*** of the controlled organization bears to the greater of:

1) The taxable income of the controlled organization, or

2) The excess taxable income of the controlled organization.

Both are determined without regard to any amount paid directly or indirectly to the controlling organization.

The controlling organization is allowed all deductions directly connected with the amounts included in gross income.

The controlled organization's excess taxable income is the excess of its taxable income over the taxable income that, if derived directly by the controlling organization, would not be unrelated business taxable income.

Example. A, an exempt university, owns all the stock of M, a nonexempt organization. During the year, M leases a factory and a dormitory from A for a total annual rental of $100,000. During the tax year, M has $500,000 of taxable income, disregarding the rent paid to A. M's taxable income consists of $150,000 from a dormitory for students of A university, and $350,000 from operating a factory that is a business unrelated to A's exempt purpose. A's deductions for the year with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, the amount of the rent paid by M that will be included by A as net rental income in determining its unrelated business taxable income is $56,000, computed as follows:

M's taxable income (disregarding rent paid to A)	$500,000
Less taxable income from dormitory	150,000
Excess taxable income	$350,000
Ratio (350,000/500,000)	7/10
Total rent paid to A	$100,000
Total deductions ($4,000 + $16,000)	$ 20,000
Rental income treated as gross income from an unrelated trade or business (7/10 of $100,000)	$ 70,000
Less deductions directly connected with that income (7/10 of $20,000)	14,000
Net rental income included by A in computing its unrelated business taxable income	$ 56,000

Income from controlled organizations (for tax years beginning after August 5, 1997). The following rules apply to tax years beginning after August 5, 1997. However, they do not apply to payments under a binding contract in effect on June 8, 1997, and at all times thereafter before the payment, if made during the first 2 tax years beginning after August 4, 1997. See *Income from controlled organizations (for tax years beginning before August 6, 1997),* earlier.

The exclusions for interest, annuities, royalties, and rents explained earlier in this chapter do not apply to a payment received

by a controlling organization from its controlled organization, to the extent the payment reduces the net unrelated income (or increases the net unrelated loss) of the controlled organization. All deductions of the controlling organization directly connected with the amount included in its unrelated business taxable income are allowed.

Net unrelated income. This is:

- For an exempt organization, its unrelated business taxable income, or
- For a nonexempt organization, the part of its taxable income that would be unrelated business taxable income if it were exempt and had the same exempt purposes as the controlling organization.

Net unrelated loss. This is:

- For an exempt organization, its net operating loss, or
- For a nonexempt organization, the part of its net operating loss that would be its net operating loss if it were exempt and had the same exempt purposes as the controlling organization.

Control. An organization is controlled if:

- For a corporation, the controlling organization owns (by vote or value) more than 50% of the stock,
- For a partnership, the controlling organization owns more than 50% of the profits or capital interests, or
- For any other organization, the controlling organization owns more than 50% of the beneficial interest.

For this purpose, constructive ownership of stock (determined under section 318) or other interests is taken into account.

Therefore, an exempt parent organization is treated as controlling any subsidiary in which it holds more than 50% of the voting power or value, whether directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

5.

Debt-Financed Property

Income that would otherwise be excluded may be subject to unrelated business income tax if it is, and to the extent it is, derived from debt-financed property (defined below). This chapter describes debt-financed property and the exceptions to this classification. The property must be subject to an acquisition indebtedness at some time during the tax year to be debt-financed property. Acquisition indebtedness is discussed in chapter 6.

The computation of unrelated debt-financed income from debt-financed property is discussed in chapter 7.

Debt-financed property defined. The term debt-financed property means any property held to produce income, and for which there is acquisition indebtedness at any time during the tax year (or 12-month period before the disposition date of that property). Whether there is acquisition indebtedness is determined without regard to whether the property is debt-financed property.

Property held to produce income. Property held to produce income includes rental real estate, tangible personal property, and corporate stock. The term ***income*** is not limited to recurring income but also applies to gains from the disposition of property. Thus, when any property an organization held to produce income (the use of which is not excepted as discussed next) is disposed of at a gain during the tax year and there was an acquisition indebtedness outstanding on this property at any time during the 12-month period before the disposition (even if that period covers more than one tax year), the property is debt-financed property.

Exceptions to Debt-Financed Property

Property related to exempt purposes. If substantially all (85% or more) of the use any property is substantially related to an organization's exempt purposes, the property is not treated as debt-financed property. Related use does not include a use related solely to the organization's need for income, or its use of the profits. The extent to which property is used for a particular purpose is determined on the basis of all the facts. They may include:

1) A comparison of the time the property is used for exempt purposes with the total time the property is used,
2) A comparison of the part of the property that is used for exempt purposes with the part used for all purposes, or
3) Both of these comparisons.

If less than 85% of the use of any property is devoted to an organization's exempt purposes, only that part of the property that is used to further the organization's exempt purposes is not treated as debt-financed property.

Property used in an unrelated trade or business. To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, the property is not treated as debt-financed property. However, any gain on the disposition of the property that is not included in income from an unrelated trade or business is includible as gross income derived from, or on account of, debt-financed property.

The rules for debt-financed property do not apply to rents from personal property, certain passive income from controlled organizations, and other amounts that are required by other rules to be included in computing unrelated business taxable income.

Property used in research activities. Property is not treated as debt-financed property when it produces gross income derived from research activities otherwise excluded from the unrelated trade or business tax. See *Income from research* in chapter 4.

Property used in certain excluded activities. Debt-financed property does not include property used in a trade or business that is excluded from the definition of "unrelated trade or business" because:

1) It has a volunteer workforce,
2) It is carried on for the convenience of its members, or
3) It consists of selling donated merchandise.

See *Excluded Trade or Business Activities* in chapter 3.

Related exempt uses. Property owned by an exempt organization and used by a related exempt organization, or by an exempt organization related to that related exempt organization, is not treated as debt-financed property when the property is used by either organization to further its exempt purpose. Furthermore, property is not treated as debt-financed property when a related exempt organization uses it for research activities or certain excluded activities, as described above.

Related organizations. An exempt organization is related to another exempt organization only if:

1) One organization is an exempt holding company and the other receives profits derived by the exempt holding company,
2) One organization controls the other as discussed under *Income from controlled organizations* under *Modifications* in chapter 4,
3) More than 50% of the members of one organization are members of the other, or
4) Each organization is a local organization directly affiliated with a common state, national, or international organization that also is exempt.

Medical clinics. Real property is not debt-financed property if it is leased to a medical clinic and the lease is entered into primarily for purposes related to the lessor's exercise or performance of its exempt purpose.

For example, an exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons. They, under the lease, agree to provide all of the hospital's outpatient medical and surgical services and to train all of the hospital's residents and interns. In this case the rents received are not unrelated debt-financed income.

Life income contract. If an individual transfers property to a trust or a fund with the income payable to that individual, or other individuals for a period not to exceed the life of the individual or individuals, and with the remainder payable to an exempt charitable organization, the property is not treated as debt-financed property. This exception applies only where the payments to the individual are not the proceeds of a sale or exchange of the property transferred.

Neighborhood land rule. If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property that the organization uses for exempt

purposes. This rule applies only if the intent to demolish any existing structures and use the land for exempt purposes within 10 years is not abandoned.

Property is considered in the ***neighborhood*** of property that an organization owns and uses for its exempt purposes if it is contiguous with the exempt purpose property or would be contiguous except for an intervening road, street, railroad, stream, or similar property. If it is not contiguous with the exempt purpose property, it still may be in the same neighborhood if it is within one mile of the exempt purpose property and if the facts and circumstances make it unreasonable to acquire the contiguous property.

Some issues to consider in determining whether acquiring contiguous property is unreasonable include the availability of land and the intended future use of the land.

For example, a university tries to buy land contiguous to its present campus, but cannot 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 buys this land. Under these circumstances, the contiguity requirement is unreasonable and not applicable. The land bought would be considered neighborhood land.

Exceptions. For all organizations other than churches and conventions or associations of churches, discussed later under *Churches,* the neighborhood land rule does not apply to property after the 10 years following its acquisition. Further, the rule applies after the first 5 years only if the organization satisfies the IRS that use of the land for exempt purposes is reasonably certain before the 10-year period expires. The organization need not show binding contracts to satisfy this requirement; but it must have a definite plan detailing a specific improvement and a completion date, and it must show some affirmative action toward the fulfillment of the plan. This information should be forwarded to the IRS for a ruling at least 90 days before the end of the 5th year after acquisition of the land. Address it to:

IRS CP:E:EO
P.O. Box 120 Franklin Station
Washington, DC 20224

The IRS may grant a reasonable extension of time for requesting the ruling if the organization can show good cause. For more information, contact the IRS.

Actual use. If the neighborhood land rule does not apply because the acquired land is not in the neighborhood of other land used for an organization's exempt purposes, or because the organization fails to establish after the first 5 years of the 10-year period that the property will be used for exempt purposes, but the land is used eventually by the organization for its exempt purposes within the 10-year period, the property is not treated as debt-financed property for any period before the conversion.

Limits. The neighborhood land rule or actual use rule applies 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 in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in this manner. Thus, during the first 5 years after acquisition (and for later years if there is a favorable ruling), improved property is not debt financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. If an actual demolition of these structures occurs, the use made of the land need not be the one originally intended as long as its use furthers the organization's exempt purpose.

In addition to this limit, the neighborhood land rule and the actual use rule do not apply to structures erected on land after its acquisition. They do not apply to property subject to a ***business lease*** (as defined in section 514 immediately before the Tax Reform Act of 1976) whether an organization acquired the property subject to the lease, or whether it executed the lease after acquisition. A business lease is any lease, with certain exceptions, of real property for a term of more than 5 years by an exempt organization if at the close of the lessor's tax year there is a business lease (acquisition) indebtedness on that property.

Refund of taxes. When the neighborhood land rule does not initially apply, but the land is used eventually for exempt purposes, a refund or credit of any overpaid taxes will be allowed for a prior tax year as a result of the satisfaction of the actual use rule. A claim must be filed within one year after the close of the tax year in which the actual use rule is satisfied. Interest rates on any overpayment are governed by the regulations.

Example. In January 1989, Y, a calendar year exempt organization, acquired real property contiguous to other property that Y uses in furtherance of its exempt purpose. Assume that without the neighborhood land rule, the property would be debt-financed property. Y did not satisfy the IRS by January 1994 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 1994 until the property is converted to an exempt use, the income from the property is subject to the tax on unrelated business income. During July 1998, Y will demolish the existing structure on the land and begin using the land in furtherance of its exempt purpose. At that time, Y can file claims for refund for the open years 1995 through 1997.

Further, Y also can file a claim for refund for 1994, even though a claim for that tax year may be barred by the statute of limitations, provided the claim is filed before the close of 1999.

Churches. The neighborhood land rule as described here also applies to churches, or a convention or association of churches, but with two differences:

1) The period during which the organization must demonstrate the intent to use acquired property for exempt purposes is increased from 10 to 15 years, and

2) Acquired property does not have to be in the neighborhood of other property used by the organization for exempt purposes.

Thus, if a church or association or convention of churches acquires real property for the primary purpose of using the land in the exercise or performance of its exempt purpose, within 15 years after the time of acquisition, the property is not treated as debt-financed property as long as the organization does not abandon its intent to use the land in this manner within the 15-year period.

This exception for a church or association or convention of churches does not apply to any property after the 15-year period expires. Further, this rule will apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the IRS that use of the acquired land in furtherance of the organization's exempt purpose is reasonably certain before the 15-year period expires.

If a church or association or convention of churches cannot establish after the first 5 years of the 15-year period that use of acquired land for its exempt purpose is reasonably certain within the 15-year period, but the land is in fact converted to an exempt use within the 15-year period, the land is not treated as debt-financed property for any period before the conversion.

The same rule for demolition or removal of structures as discussed earlier under *Limits* applies to a church or an association or a convention of churches.

Basis for Debt-Financed Property Acquired in Corporate Liquidation

If an exempt organization acquires debt-financed property in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in the property is the same as it would be in the hands of the transferor corporation. This basis is increased by the gain recognized to the transferor corporation upon the distribution and by the amount of any gain that, because of the distribution, is includible in the organization's gross income as unrelated debt-financed income.

6.

Acquisition Indebtedness

To be “debt-financed property” (described in chapter 5), property of an exempt organization must be subject to acquisition indebtedness at some time during the tax year. This chapter defines “acquisition indebtedness” and describes the kinds of debt that are included and not included in that definition.

Acquisition indebtedness defined. Acquisition indebtedness means, for any debt-financed property, the unpaid amount of:

1) Debt incurred by the organization when acquiring or improving the property,

2) Debt incurred ***before*** acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement, and

3) Debt incurred ***after*** the acquisition or improvement of the property if:

a) The debt would not have been incurred except for the acquisition or improvement, and

b) Incurring the debt was reasonably foreseeable when the property was acquired or improved.

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 does not necessarily mean that incurring the debt later was not reasonably foreseeable.

Example 1. 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, would not 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.

Example 2. X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners will share equally in the profits of the partnership, each will invest $3 million, and X will be a limited partner. X invests $1 million of its own funds in the partnership and $2 million of borrowed funds.

The partnership buys as its sole asset an office building that it leases to the public for nonexempt purposes. The office building costs the partnership $24 million, of which $15 million is borrowed from Y bank. The loan is secured by a mortgage on the entire office building. By agreement with Y bank, X is not personally liable for payment of the mortgage.

X has acquisition indebtedness of $7 million. This amount is the $2 million debt X incurred in acquiring the partnership interest, plus the $5 million that is X's allocable part of the partnership's debt incurred to buy the office building (one-third of $15 million).

Example 3. A labor union advanced funds, from existing resources and without any borrowing, to its tax-exempt subsidiary title-holding company. The subsidiary used the funds to pay a debt owed to a third party that was previously incurred in acquiring two income-producing office buildings. Neither the union nor the subsidiary has incurred any further debt in acquiring or improving the property. The union has no outstanding debt on the property. The subsidiary's debt to the union is represented by a demand note on which the subsidiary makes payments whenever it has the available cash. The books of the union and the subsidiary list the outstanding debt as interorganizational indebtedness.

Although the subsidiary's books show a debt to the union, it is not the type subject to the debt-financed property rules. In this situation, the very nature of the title-holding company and the parent-subsidiary relationship shows this debt to be merely a matter of accounting between the two organizations. Accordingly, the debt is not acquisition indebtedness.

Change in Use of Property

Debt on property that is not debt-financed property (described under *Exceptions to Debt-Financed Property* in chapter 5) is not acquisition indebtedness. However, if an organization converts this 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.

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.

Continued Debt

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 was not debt-financed property.

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 was not debt-financed property. The organization later sold the building for $1,000,000 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.

Property Acquired Subject to Mortgage or Lien

Generally, whenever property is acquired subject to a mortgage, the outstanding principal debt secured by that mortgage is treated as acquisition indebtedness even if the organization did not assume or agree to pay the debt. For an exception, see *Property Acquired by Gift, Bequest, or Devise,* next.

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.

Other liens. 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 is not treated as a mortgage until after the taxes or assessments have become due and payable and the organization has had an opportunity to pay the lien in accordance with state law. Liens similar to mortgages include (but are not limited to):

1) Deeds of trust,
2) Conditional sales contracts,
3) Chattel mortgages,
4) Security interests under the Uniform Commercial Code,
5) Pledges,
6) Agreements to hold title in escrow, and
7) Liens for taxes or assessments (other than those discussed earlier).

Property Acquired by Gift, Bequest, or Devise

If property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal debt secured by the mortgage is not treated as acquisition indebtedness during the 10-year period following the date the organization receives the property.

If an organization receives a gift of property subject to a mortgage, the outstanding principal debt secured by the mortgage is not treated as acquisition indebtedness during the 10-year period following the date the organization receives the gift, as long as:

1) The mortgage was placed on the property more than 5 years before the date of the gift, and
2) The donor held the property for more than 5 years before the date of the gift.

For these purposes, the date of the gift is the date the organization receives the property.

These exceptions do not 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 (other than an annuity payment excluded from the definition of acquisition indebtedness, discussed later under *Annuity Obligation*).

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.

Modifying Existing Debt

Extending, renewing, or refinancing an existing debt is considered to be a continuation of that debt to the extent its outstanding principal does not 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.

Extension or renewal. In general, any modification or substitution of the terms of a debt by an organization is considered an extension or renewal of the original debt, rather than the start of a new one, to the extent that the outstanding principal of the debt does not increase.

The following are examples of acts resulting in the extension or renewal of a debt:

1) Substituting liens to secure the debt,
2) Substituting obligees whether or not with the organization's consent,
3) Renewing, extending, or accelerating the payment terms of the debt, and
4) Adding, deleting, or substituting sureties or other primary or secondary obligors.

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 between the old debt and the excess.

Example. An organization has an outstanding principal debt of $500,000 that is treated as acquisition indebtedness. The organization borrows another $100,000, which is not 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 X $500,000/$600,000) and the excess debt by $10,000.

Debt Incurred in Performing Exempt Purpose

A debt incurred in performing an exempt purpose is not acquisition indebtedness. For example, acquisition indebtedness does not include the debt an exempt credit union incurs in accepting deposits from its members or the debt an exempt organization incurs in accepting payments from its members to provide them with insurance, retirement, or other benefits.

Annuity Obligation

The organization's obligation to pay an annuity is not acquisition indebtedness if the annuity meets all the following requirements:

1) It must be the sole consideration (other than a mortgage that is discussed under *Property Acquired by Gift, Bequest, or Devise* earlier in this chapter) issued in exchange for the property received,
2) Its present value, at the time of exchange, must be less than 90% of the value of the prior owner's equity in the property received,
3) It must be payable over the lives of either one or two individuals living when issued, and
4) It must be payable under a contract that:
   a) Does not guarantee a minimum nor specify a maximum number of payments, and
   b) Does not provide for any adjustment of the amount of the annuity payments based on the income received from the transferred property or any other property.

For information about computing the present value of an annuity at the time of exchange, contact the IRS at (410) 962–6058 or (410) 962–6059. The call is not toll free.

Example. On January 1, 1998, X, an exempt organization, receives property valued at $100,000 from donor A, a male age 60. In return X promises to pay A $6,000 a year for the rest of A's life, with neither a minimum nor maximum number of payments specified. The annuity is payable on December 31 of each year. The amounts paid under the annuity are not dependent on the income derived from the property transferred to X. The present value of this annuity is $81,156, determined from IRS valuation tables. Since the value of the annuity is less than 90 percent of A's $100,000 equity in the property transferred and the annuity meets all the other requirements just discussed, the obligation to make annuity payments is not acquisition indebtedness.

Securities Loans

Acquisition indebtedness does not include an obligation of the exempt organization to return collateral security provided by the borrower of the exempt organization's securities under a securities loan agreement (discussed under *Gross Income—Exclusions* in chapter 4). This transaction is not treated as the borrowing by the exempt organization of the collateral furnished by the borrower (usually a broker) of the securities.

However, if the exempt organization incurred debt to buy the loaned securities, any income from the securities (including income from lending the securities) would be debt-financed income. For this purpose, any payments with respect to securities loans are considered to be from the securities loaned and not from collateral security or the investment of collateral security from the loans. Any deductions that are directly connected with collateral security for the loan, or with the investment of collateral security, are considered deductions that are directly connected with the securities loaned.

Short sales. Acquisition indebtedness does not include the “borrowing” of stock from a broker to sell the stock short. Although a short sale creates an obligation, it does not create debt.

Real Property Debts of Qualified Organizations

In general, acquisition indebtedness does not include debt incurred by a qualified organization in acquiring or improving any real property. A ***qualified organization*** is:

1) A qualified retirement plan under section 401(a),
2) An educational organization described in section 170(b)(1)(A)(ii) and certain of its affiliated support organizations, or
3) A title-holding company described in section 501(c)(25).

This exception from acquisition indebtedness ***does not apply*** in the following six situations:

1) The acquisition price is not a fixed amount determined as of the date of the acquisition or the completion of the improvement. However, the terms of a sales contract may provide for price adjustments due to customary closing adjustments such as prorating property taxes. The contract also may provide for a price adjustment if it is for a fixed amount dependent upon subsequent resolution of limited, external contingencies such as zoning approvals, title clearances, and the removal of easements. These conditions in the contract will not cause the price to be treated as an undetermined amount. (But see *Note 1* at the end of this list.)
2) Any debt or other amount payable for the debt, or the time for making any payment, depends, in whole or in part, upon any revenue, income, or profits derived from the real property. See *Note 1* at the end of this list also.
3) The real property is leased back to the seller of the property or to a person related to the seller as described in section 267(b) or section 707(b). (But see *Note 2* at the end of this list also.)
4) The real property is acquired by a qualified retirement plan from, or after its acquisition is leased by a qualified retirement plan to, a related person. (But see *Note 2* at the end of this list.) For this purpose, a related person is:
   a) An employer who has employees covered by the plan,
   b) An owner with at least a 50% interest in an employer described in (a),
   c) A member of the family of any individual described in (a) or (b),
   d) A corporation, partnership, trust, or estate in which a person described in (a), (b), or (c) has at least a 50% interest, or
   e) An officer, director, 10% or more shareholder, or highly compensated employee of a person described in (a), (b), or (d).
5) The seller, a person related to the seller (under section 267(b) or section 707(b)), or a person related to a qualified retirement plan (as described in (4)) provides financing for the transaction on other than commercially reasonable terms.
6) The real property is held by a partnership in which an exempt organization is a partner (along with taxable entities), and the principal purpose of any allocation to an exempt organization is to avoid tax. This generally applies to property placed in service after 1986. For more information, see section 514(c)(9)(B)(vi) and section 514(c)(9)(E).

Note 1: Qualifying sales by financial institutions of foreclosure property or certain conservatorship or receivership property are not included in (1) or (2) and, therefore, do not give rise to acquisition indebtedness. For more information, see section 514(c)(9)(H).

Note 2: For purposes of (3) and (4), small leases are disregarded. A small lease is one that covers no more than 25% of the leasable floor space in the property and has commercially reasonable terms.

Certain Federal Financing

Acquisition indebtedness does not include an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low or moderate income people.

7. Unrelated Debt-Financed Income

This chapter explains the treatment of unrelated debt-financed income by tax-exempt organizations.

All tax-exempt organizations subject to the tax on unrelated business income must include, with this income, unrelated debt-financed income from debt-financed property (defined in chapter 5). The income included is proportionate to the debt on the property. Various types of investment income are included, but only if the income arises from property acquired or improved with borrowed funds and if the production of income is unrelated to the purpose constituting the basis of the organization's tax exemption.

Computation of Debt-Financed Income

For each debt-financed property, the unrelated debt-financed income is a percentage (not over 100%) of the total gross income derived during a tax year from the property. This percentage is the debt/basis percentage, and the formula for deriving unrelated debt-financed income is:

$$\frac{\text{average acquisition indebtedness}}{\text{average adjusted basis}} \times \text{gross income from debt-financed property}$$

Average acquisition indebtedness and average adjusted basis are defined later in this chapter.

Example. X, an exempt trade association, owns an office building that is debt-financed property. The building produced $10,000 of gross rental income last year. The average adjusted basis of the building during that year was $100,000, and the average acquisition indebtedness with respect to the building was $50,000. Accordingly, the debt/basis percentage was 50% (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building was $5,000 (50% of $10,000).

Gain From Sale or Other Disposition of Property

If an organization sells or otherwise disposes of debt-financed property, it must include, in computing unrelated business taxable income, a percentage (not over 100%) of any gain or loss. The percentage is that of the highest acquisition indebtedness with respect to the property during the 12-month period preceding the date of disposition, in relation to the property's average adjusted basis.

The tax on this percentage of gain or loss is determined according to the usual rules for capital gains and losses. These amounts may be subject to the alternative minimum tax. (See *Alternative minimum tax* at the beginning of chapter 2.)

Debt-financed property exchanged for subsidiary's stock. A transfer of debt-financed property by a tax-exempt organization to its wholly owned taxable subsidiary, in exchange for additional stock in the subsidiary, is not considered a gain subject to the tax on unrelated business income.

Example. A tax-exempt hospital wants to build a new hospital complex to replace its present old and obsolete facility. The most desirable location for the new hospital complex is a site occupied by an apartment complex. Several years ago the hospital bought the land and apartment complex, taking title subject to a first mortgage already on the premises.

For valid business reasons, the hospital proposed to exchange the land and apartment complex, subject to the mortgage on the property, for additional stock in its wholly owned subsidiary. The exchange satisfied all the requirements of section 351(a).

The transfer of appreciated debt-financed property from the tax-exempt hospital to its wholly owned subsidiary in exchange for stock did not result in a gain subject to the tax on unrelated business income.

Average Acquisition Indebtedness

One of the factors in determining unrelated debt-financed income is the average acquisition indebtedness of the debt-financed property. The term “average acquisition indebtedness” means the average amount of outstanding principal debt during the part of the tax year that the organization holds the property.

Average acquisition indebtedness is computed by determining how much principal debt is outstanding on the first day in each calendar month during the tax year that the organization holds the property, adding these amounts, and dividing the sum by the number of months during the year that the organization held the property. Part of a month is treated as a full month in computing average acquisition indebtedness.

Average Adjusted Basis

The average adjusted basis of debt-financed property is the average of the adjusted basis of the property as of the first day and as of the last day that the organization holds the property during the tax year.

Determining the average adjusted basis of the debt-financed property is not affected if the organization was exempt from tax for prior tax years. The basis of the property must be adjusted properly for the entire period after the property was acquired. As an example, adjustment must be made for depreciation during all prior tax years whether or not the organization was tax-exempt. If only part of the depreciation allowance may be taken into account in computing the percentage of deductions allowable for each debt-financed property, that does not affect the amount of the depreciation adjustment to use in determining average adjusted basis.

Computation of Debt/Basis Percentage

The following example shows how to compute the debt/basis percentage by first determining the average acquisition indebtedness and average adjusted basis.

Example. On July 7, an exempt organization buys an office building for $510,000 using $300,000 of borrowed funds. The organization files its return on a calendar year basis. During the year the only adjustment to basis is $20,000 for depreciation. Starting July 28, the organization pays $20,000 each month on the mortgage principal plus interest. The debt/basis percentage for the year is calculated as follows:

Month	Debt on first day of each month property is held
July	$ 300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	$1,500,000
Average acquisition indebtedness: $1,500,000 ÷ 6 months	$ 250,000

	Basis
As of July 7	$ 510,000
As of December 31	490,000
Total	$1,000,000
Average adjusted basis: $1,000,000 ÷ 2	$ 500,000

Debt/basis percentage

$$\frac{\$250{,}000}{\$500{,}000} = 50\%$$

Indeterminate Price

If an organization acquires or improves property for an indeterminate price (that is, neither the price nor the debt is certain), the unadjusted basis and the initial acquisition indebtedness are determined as follows, unless the organization obtains the IRS's consent to use another method. The unadjusted basis is the fair market value of the property or improvement on the date of acquisition or completion of the improvement. The initial acquisition indebtedness is the fair market value of the property or improvement on the date of acquisition or completion of the improvement, less any down payment or other initial payment applied to the principal debt. The average adjusted basis and the average acquisition indebtedness are then determined the same way as discussed earlier.

Deductions

The deductions allowed for each debt-financed property are determined by applying the debt/basis percentage to the sum of allowable deductions.

The allowable deductions are those directly connected with the debt-financed property or with the income from it (including the dividends-received deduction), except that:

1) The allowable deductions are subject to the modifications for computation of the unrelated business taxable income (discussed in chapter 4), and
2) The depreciation deduction, if allowable, is computed only by use of the straight-line method.

To be ***directly connected*** with debt-financed property or with the income from it, a deductible item must have proximate and primary relationship to the property or income. Expenses, depreciation, and similar items attributable solely to the property qualify for deduction, to the extent they meet the requirements of an allowable deduction.

For example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization can deduct depreciation of $10,000 if the entire building is debt-financed property. However, if only half of the building is debt-financed property, the depreciation allowed as a deduction is $5,000.

Capital losses. If a sale or exchange of debt-financed property results in a capital loss, the loss taken into account in the tax year in which the loss arises is computed as provided under *Gain From Sale or Other Disposition of Property,* earlier in this chapter.

If any part of the allowable capital loss is not taken into account in the current tax year, it may be carried back or carried over to another tax year without application of the debt/basis percentage for that year.

Example. X, an exempt educational organization, owned debt-financed securities that were capital assets. Last year, X sold the securities at a loss of $20,000. The debt/basis percentage for computing the loss from the sale of the securities is 40%. Thus, X sustained a capital loss of $8,000 (40% of $20,000) on the sale of the securities. Last year and the preceding 3 tax years, X had no other capital transactions. Under these circumstances, the $8,000 of capital loss may be carried over to succeeding years without further application of the debt/basis percentage.

Net operating loss. If, after applying the debt/basis percentage to the income from debt-financed property and the deductions directly connected with this income, the deductions exceed the income, an organization has a net operating loss for the tax year. This amount may be carried back or carried over to other tax years in the same manner as any other net operating loss of an organization with unrelated business taxable income. (For a discussion of the net operating loss deduction, see *Deductions* under *Modifications* in chapter 4.) However, the debt/basis percentage is not applied in those other tax years to determine the deductions that may be taken in those years.

Example. Last year, Y, an exempt organization, received $20,000 of rent from a debt-financed building that it owns. Y had no other unrelated business taxable income for the year. The deductions directly connected with this building were property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the building manager. The debt/basis percentage with respect to the building was 50%. Under these circumstances, Y must take into account, in computing its unrelated business taxable income, $10,000 (50% of $20,000) of income and $12,500 (50% of $25,000) of the deductions directly connected with that income.

Thus, Y sustained a net operating loss of $2,500 ($10,000 of income less $12,500 of deductions), which may be carried back or carried over to other tax years without further application of the debt/basis percentage.

Allocation Rules

When only part of the property is debt-financed property, proper allocation of the basis, debt, income, and deductions with respect to the property must be made to determine how much income or gain derived from the property to treat as unrelated debt-financed income.

Example. X, an exempt college, owns a four-story office building that it bought with borrowed funds (assumed to be acquisition indebtedness). During the year, the lower two stories of the building were used to house computers that X uses for administrative purposes. The two upper stories were rented to the public and used for nonexempt purposes.

The gross income X derived from the building was $6,000, all of which was attributable to the rents paid by tenants. The expenses were $2,000 and were equally allocable to ***each use*** of the building. The average adjusted basis of the building for the year was $100,000 and the average acquisition indebtedness for the year was $60,000.

Since the two lower stories were 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 this income are taken into account in computing unrelated business taxable income. The part taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with the rental income by the debt/basis percentage.

The debt/basis percentage is the ratio of the allocable part of the average acquisition indebtedness to the allocable part of the property's average adjusted basis: that is, in this case, the ratio of $30,000 (one-half of $60,000) to $50,000 (one-half of $100,000). Thus, the debt/basis percentage for the year is 60% (the ratio of $30,000 to $50,000).

Under these circumstances, X must include net rental income of $3,000 in its unrelated business taxable income for the year, computed as follows:

Rental income treated as gross income from an unrelated trade or business (60% of $6,000)	$3,600
Less the allowable portion of deductions directly connected with that income (60% of $1,000)	600
Net rental income included by X in computing its unrelated business taxable income from debt-financed property.	$3,000

8. How To Get More Information

You can get help from IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our “800 number” telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Evaluating agency enforcement actions. The Small Business and Agriculture Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small business about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of the IRS, call 1–888–734–3247.

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