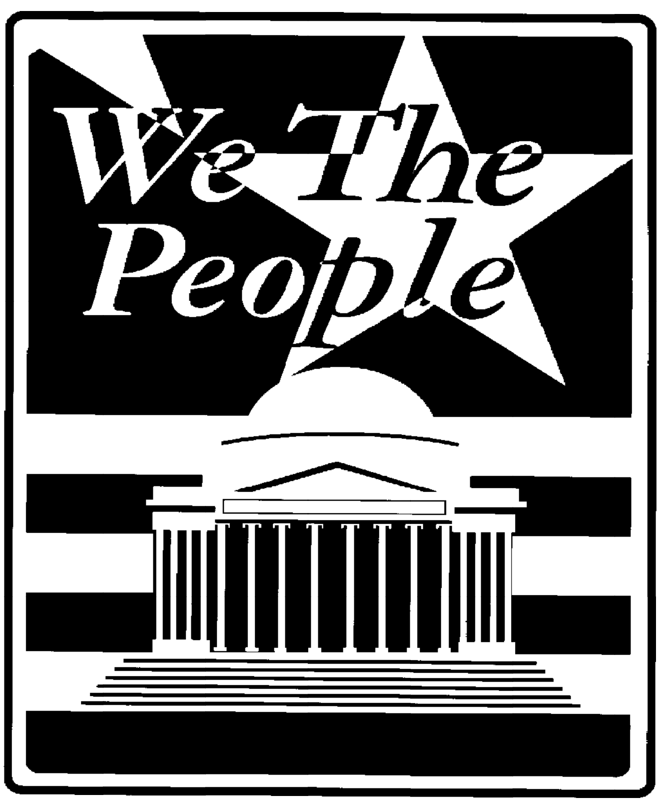
Publication 598
(Rev. Feb. 95)
Cat. No. 46598X

Department of the Treasury
Internal Revenue Service

Tax on Unrelated Business Income of Exempt Organizations



Contents

Important Changes

Estimated tax payments. An exempt organization must make estimated tax payments if it expects its tax (unrelated business income tax minus credits) to be $500 or more. Generally, to avoid the estimated tax penalty, the amount of estimated tax payments required by the organization is 100% of the organization's current tax year liability. For more information, see *Payment of Tax* in chapter 1.

Taxation of income from gambling activities. Income from gambling activities other than bingo conducted by exempt organizations outside of North Dakota is generally treated as unrelated business income. For more information, see *Income from gambling activities other than bingo* in chapter 2.

Exclusion of income from ordinary and routine investments. Generally, 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 Commissioner 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. For more information see *Exclusions* in chapter 3.

Acquisition indebtedness - real property. In general, acquisition indebtedness does not include debt incurred by a qualified organization in acquiring or improving any real property. The exceptions to this general rule have been modified for acquisitions on or after January 1, 1994. For more information see notes 1 and 2 to the 6 exceptions listed under *Real Property Acquired by Qualified Organization* in chapter 5.

Introduction

This publication explains the unrelated business income tax provisions that apply to most tax-exempt organizations. Generally, a tax-exempt organization with gross income of $1,000 or more for the year from an unrelated trade or business must file a tax return (Form 990–T, *Exempt Organization Business Income Tax Return*) and pay any tax due.

A basic principle that establishes exemption from income taxes is that an organization is exempt only if its primary purpose is to engage in the type of activity for which it claims exemption. Many exempt organizations operate trades or businesses that further their exempt purposes. Some operate trades or businesses that have little or no relationship to their exempt purposes, except to provide funds to carry out those purposes. The income from an unrelated business may be taxed.

The trade or business must be one that is regularly carried on and not substantially related to carrying out the exempt purpose for which the organization exists.

An exempt organization's income from debt-financed property is treated as unrelated business income and is subject to tax in the same proportion as the property remains financed by the debt. In general, debt-financed property is any property, such as rental real estate, tangible personal property, or corporate stock, that the organization finances by debt and holds to produce income instead of for exempt purposes. See Chapters 4 through 6.

For your information, 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

Free publications and forms. If you need information on a subject not covered in this publication, you may check our other free publications. To order publications and forms, call 1–800–TAX–FORM (1–800–829–3676) or write the Internal Revenue Service (IRS) Distribution Center for your area as shown in the income tax package.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call **1-800-829-4050** with your tax questions or to order forms and publications. See your tax package for the hours of operation.

1. Imposition and Rates of Tax

The tax on unrelated business income applies to all organizations exempt from tax under section 501(a) **except** certain ***U.S. instrumentalities.*** State and municipal colleges and universities are subject to this tax on unrelated business income. In addition to the organizations specifically described in section 501(c), employees' trusts forming part of pension, profit-sharing, and stock bonus plans described in section 401(a), and individual retirement accounts described in section 408 are subject to the tax on unrelated business income.

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 also 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 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 as organized and operated for the same purposes as the exempt payee organization. Thus, for a title-holding corporation whose source of income is related to the exempt functions of the exempt payee organization, that income will not be subject to the unrelated business income tax if the holding corporation and the payee organization file a consolidated return. A title-holding corporation is subject to unrelated business tax if one of its parent organizations is subject to the 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.

Section 501(c)(25) title-holding organization. For tax years beginning after 1986, a new type of tax-exempt title-holding organization was added to the list of organizations in section 501(c). This organization, described in section 501(c)(25), is a corporation or trust that:

1) Has no more than 35 shareholders or beneficiaries,
2) Has only one class of stock or beneficial interest, and
3) Is organized exclusively to acquire, hold title to, and collect income from real property and to distribute the net income to one or more eligible tax-exempt organizations that are shareholders or beneficiaries.

Eligible shareholders or beneficiaries are qualified pension plans under section 401(a); governmental plans under section 414(d); federal or state political subdivisions, agencies or instrumentalities; and tax-exempt charitable organizations described in sections 501(c)(3) and 501(c)(25).

Tax Rates

All organizations subject to the tax on unrelated business income, except trusts, are taxable at corporate rates on that income. All exempt trusts that are subject to these provisions, and that, if not exempt, would be taxable as trusts, are taxable at trust rates on unrelated business taxable income. However, an exempt trust may not claim the deduction for a personal exemption that is normally allowed to a trust.

An exempt organization that has unrelated business taxable income may be subject to the ***alternative minimum tax.*** The organization is liable for this tax if certain tax preference items are included in its determination of unrelated business taxable income.

Form 4626, *Alternative Minimum Tax—Corporations,* and Schedule H of Form 1041, *U.S. Income Tax Return for Estates and Trusts,* should be used for computing this tax. For more information on the alternative minimum tax for corporations, see Publication 542, *Tax Information on Corporations.*

Returns and Filing Requirements

An exempt organization subject to the tax on unrelated business income must file its income tax return on ***Form 990–T,*** *Exempt Organization Business Income Tax Return,* and attach any required supporting schedules and forms. The return is filed with the appropriate Service Center.

This return is required only if the gross income from an unrelated business is $1,000 or more. The obligation to file Form 990–T is in addition to the obligation to file any other required returns.

Each entity subject to the unrelated business income tax must report all of its unrelated business taxable income on a single Form 990–T. Unless the provisions of section 1504(e) (relating to consolidated returns) apply, more than one legal entity cannot file on the same Form 990–T.

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 returns filed on Form 990–T.

Due date. The income tax return (Form 990–T) of an organization exempt from tax under section 501(a) (other than an employees' trust described in section 401(a)) must be filed by the 15th day of the 5th month after the tax year ends. An employees' trust must file Form 990–T by the 15th day of the 4th month after its tax year ends.

Extension of Time To File a Return

Corporations. A corporation requesting an automatic extension of 6 months for filing a return must submit Form 7004, *Application for Automatic Extension of Time To File Corporation Income Tax Return.*

Trusts. A trust may request an extension for filing 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 Returns

Annual information returns filed by exempt organizations are available for public inspection. An exempt organization's income tax return (Form 990–T) is not available for public inspection.

Payment of Tax

Estimated tax. Tax-exempt organizations must make quarterly payments of estimated tax on unrelated business income, under the same rules as corporations. The organization must make estimated tax payments if it expects its tax (unrelated business income tax minus credits) to be $500 or more. Estimated tax payments are generally due by the l5th day of the 4th, 6th, 9th, and l2th months of the tax year. If any date falls on a Saturday, Sunday, or legal holiday, substitute the next regular workday. 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 for tax years beginning after 1993, the amount of estimated tax payments required by the organization is 100% of the organization's current tax year liability. A small corporation can use 100% of the tax shown on its return for the preceding year to determine each installment unless no tax is shown. A ''large'' corporation can base its first required installment on 100% of the prior year's liability, but not subsequent installments. A large corporation is one with taxable income of $1,000,000 or more for any taxable year in the ''testing period.'' The testing period is the 3 years immediately preceding the current year.

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.

Method of payment. Domestic organizations and foreign organizations with an office or place of business in the United States must deposit all income tax payments and estimated tax payments with a Federal Tax Deposit Coupon (Form 8109). These deposits must be made with an authorized financial institution or Federal Reserve Bank in accordance with the instructions on the coupon.

All trusts, and foreign corporations without an office or place of business in the United States, may pay the tax by check or money order (in U.S. dollars) payable to the Internal Revenue Service.

Tax Credits

General business credit. The organization should use Form 3800, *General Business Credit,* to figure its combined credit if it has 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 these credits. The separate forms are Form 3468, *Investment Credit* and Form 6478, *Credit for Alcohol Used as Fuel.*

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 Allowed Under Section 936.*

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

2. Unrelated Trade or Business (UTB)

An exempt organization is subject to tax on unrelated business income ***(UBI)*** if the income is from a ***trade or business*** which is ***regularly carried on*** by the organization and which is not ***substantially related*** to the performance by the organization of its exempt purpose or function except that the organization needs the profits derived from this activity.

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. It is not limited to integrated aggregates of assets, activities, and goodwill that comprise businesses for the purposes of certain other provisions of the Internal Revenue Code.

Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other 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 is 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. Another example of a trade or business being carried on within a larger complex of activities is soliciting, selling, and publishing commercial advertising for publication 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 will be considered to be 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 taxpaying 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.

Substantially related. To determine whether a business activity is or is not substantially related requires an examination of the relationship between the business activities that generate the particular income in question and the accomplishment of the organization's exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must ***contribute importantly*** to the accomplishment of the organization's exempt purposes to be substantially related.

Contribute importantly. 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, if there is income from activities that are in part related to the performance of an organization's exempt function but the activities are conducted on a larger scale than is reasonably necessary for the performance of a function, the gross income attributable to that portion of the activities in excess of the needs of the exempt function is income from an unrelated trade or business. This income is not from the production or distribution of goods or the performance of services that contribute importantly to the accomplishment of any exempt purpose of the organization.

Unrelated business income and the ''contributes importantly'' principle as they relate to activities of an exempt organization can best be explained by the following examples.

Examples of UTB and UBI

An agricultural organization, whose primary purpose is to promote better conditions for breeders of cattle 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.

A fine arts organization was formed to stimulate and foster public interest in the fine arts by promoting art exhibits, sponsoring cultural events, and furnishing information relating to fine arts. However, leasing studio apartments to artist tenants and operating a dining hall primarily to serve these tenants has no substantial causal relationship to the achievement of the exempt purposes of the organization. Therefore such activities are unrelated trades or businesses.

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 purposes and therefore is an unrelated trade or business. For information on exchanges or rentals between certain tax-exempt organizations, see the discussion on *Exchange or rental of member lists* later, under *Examples of Things That Are Not UTB or UBI.*

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 not an unrelated trade or business.

A hospital with exempt status 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 substantially related to the hospital's exempt purpose and do not constitute unrelated trades or businesses.

Book publishing by an exempt organization. An exempt organization engages primarily in activities in furtherance of its exempt purposes. It also owns the publication rights to a book. The publication and distribution of the book do not contribute to the organization's accomplishing its exempt purposes, except for its need for the income from the sale of the book. The organization exploits the book in a commercial manner. It arranged for printing, distribution, and publicity and advertising in connection with the sale of the book. These activities constitute the conduct of a trade or business regularly carried on and the income is unrelated business taxable income. However, if the organization transfers publication rights to a commercial publisher in return for royalties, the royalty income received is not unrelated business income.

See *Royalties* discussed later under *Modifications* in Chapter 3.

An exempt vocational school operates a handicraft shop where articles made by students, as part of their regular courses of instruction, are sold. The students are paid a percentage of the sales price. In addition, the shop sells products made by local residents, many of whom are former students of the school. The local residents make articles at home according to the shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that desired standards of style and quality are met. 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.

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 conduct the affairs of the club, including collecting membership fees and scheduling court time.

Another exempt school leases the same type of facilities to an unrelated individual at a fixed fee that does not depend on the income or profits derived from the leased property. The individual forms a tennis club, hires employees, and repairs any damage to the facilities.

In both of these situations, the exempt purposes of the schools are limited to those involving the advancement of education. Furnishing tennis facilities in the manner described is not an activity that furthers this exempt purpose. Therefore, these activities are an unrelated trade or business. However, the income derived in the second situation from the leasing of the property is ***excluded*** from unrelated business taxable income as rent from real property. (See the discussion on *Rents,* under *Modifications* in Chapter 3.)

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.

The 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.

An exempt collegiate athletic conference conducts an annual competitive athletic game between the champion of the conference 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 athletic activities 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. The sale of the rights and the broadcasting of the game contributes importantly to the accomplishment of the organization's exempt purpose. Therefore, the sale of the broadcasting rights 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. Income of an exempt organization from the sale of advertising in its annual yearbook is unrelated business taxable income when an independent commercial firm, under a contract covering a full calendar year, conducts an intensive advertising solicitation campaign in the organization's name and is paid a percentage of the gross advertising receipts for selling the advertising, collecting from advertisers, and printing the yearbook.

Pet boarding and grooming services. An exempt organization, organized and operated for the prevention of cruelty to animals, receives income from providing pet boarding and grooming services for the general public. This is income from an unrelated trade or business.

An exempt art museum operates a dining room, a cafeteria, and a snack bar for use by the museum staff, employees, and members of the public visiting the museum. These activities do not constitute an unrelated trade or business. The eating facilities offered within the museum help to attract visitors to the museum exhibits. Because there are places of refreshment in the museum, visitors are able to spend a greater amount of their time viewing the museum's collections, exhibits, and other educational facilities than would be the case if they had to stop their tours of the museum 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 is a service that contributes importantly to the accomplishment of its exempt purposes.

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.

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 10 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.

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

By making available these travel tours to its members, the organization is furnishing its members with a regularly carried on commercial service. The service is not substantially related to the organization's basis for exemption, which is the promotion of education by assisting a given university, financially and otherwise, and by encouraging its member alumni to do the same.

Because there is no causal relationship between the travel tour activity and the achievement of the organization's exempt purposes, this activity does not contribute importantly to the accomplishment of the association's purposes for which it obtained tax-exempt status. Therefore, the sale of travel tours by the organization to its members 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 involved in 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.

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 purpose for which the business league was recognized as a tax-exempt organization.

Since there is no substantial causal relationship between this activity and the achievement of the organization's exempt purpose, the activity does not contribute importantly to the organization's exempt function. Therefore, the sale of this magazine is an unrelated trade or business.

An association of law enforcement officials publishes a monthly journal that contains articles and other editorial material of professional interest to its members. The organization sells advertising space in the journal. The advertising usually features the products or services of a commercial enterprise.

The publication and distribution of advertising and other messages in periodicals is a recognized form of commercial service. The fact that the message published is not of a commercial nature is not determinative. In this situation, the controlling factor is the sale and performance of a valuable service by the exempt organization, and the purchase of that service by the advertisers. Since the publication of the advertising is regularly carried on and is not substantially related to the organization's exempt purpose, the income from the advertising is unrelated trade or business income.

The commercial benefit expected by the advertisers is an important factor. However, all the facts and circumstances must be considered. 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.

A business league publishes an annual directory that contains a listing 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 serves to facilitate communication among the members and encourages the exchange of ideas and expertise. Since the directory lists the members in a similar noncommercial format without advertising and is not distributed to the public, its sale does not confer any private commercial benefit on the members. The sale of the directory contributes importantly to the accomplishment of the organization's exempt purpose. Therefore, the sale of the directory in this situation is not an unrelated trade or business. This directory differs from the journal published by the association of law enforcement officials because of its noncommercial characteristics.

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.

An art museum maintained and operated for the exhibition of modern art sells to the general public 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. It also publishes a catalog in which it solicits mail orders for the greeting cards. The catalog is available at a small charge and is advertised in magazines and other publications throughout the year. In addition, the shop sells the cards at quantity discounts to retail stores. 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. Moreover, more people may be encouraged to visit the museum itself to share in its educational programs as a result of seeing the cards. 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 to the general public:

1) Reproductions of works in the museum's own collection and reproductions of artistic works from the collections of other art museums (these reproductions take the form of 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; and
3) Instructional literature concerning the history and development of art and, in particular, of American folk art. 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.

Also sold in the shop are scientific books and souvenir items of the city in which the museum is located.

Sales of a particular line of merchandise may be considered separately to determine if they are related to the exempt purpose.

An art museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of an art collection. The sale and rental of reproductions 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 with the sale of literature relating to art. Therefore, these sales activities are not an unrelated trade or business.

On the other hand, scientific books and souvenir items of the city where the museum is located have no causal relationship to art or to artistic endeavor and, therefore, the sale of these items does not contribute importantly to the accomplishment of the organization's exempt educational purpose which, as an art museum, is to enhance the public's understanding and appreciation of art. The fact that 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 the conclusion that in this situation they do not contribute to the accomplishment of this organization's exempt educational purpose.

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, the sale of those articles having no relationship to American folk art or to art in general, does constitute an unrelated trade or business.

A business league 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 organization's main purpose is to retain and stimulate trade in a particular city's downtown area that has inadequate parking facilities.

No individual or group of downtown merchants is favored by the manner in which the fringe parking and shuttle bus are operated or in the selection of discharge and pickup points. 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.

A youth welfare organization. An exempt organization, whose purpose is to provide for the welfare of young people, rents rooms primarily to people under age 25. This income is not considered unrelated business income since the source of income is substantially related to the purpose constituting the basis for the organization's exemption.

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. A similar 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.

Examples of Things That Are Not UTB or UBI

Hospital Services. Unrelated business income does not include income that a tax-exempt hospital receives for providing certain services at or below cost only to tax-exempt hospitals with facilities to serve not more than 100 inpatients.

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.

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.

Disposition of product of exempt functions. Ordinarily, gross income from selling products that result from the performance of exempt functions does not constitute gross income from the conduct of 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 product resulting from an exempt function is used or exploited in further business endeavor beyond what is reasonably appropriate or necessary to dispose of it, as is, when the exempt function is completed, the resulting gross income would be from the conduct of an unrelated trade or business.

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 a commercial endeavor. In such cases, the use of the asset or facility for exempt functions does not, by itself, make the income from the commercial endeavor gross income from a related trade or business. The test, as discussed earlier, is whether the activities that produce the income in question 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 trade or business income.

For an allocation of expenses attributable to dual use of assets or facilities, see *Deductions and Expenses* in Chapter 3.

Exploitation of exempt functions. In some cases, exempt activities create goodwill or other intangibles that are capable of being 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 these commercial activities contribute importantly to the accomplishment of an exempt purpose, the income they produce is gross income from the conduct of an unrelated trade or business. The following examples illustrate this principle.

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. While 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.

For the treatment of expense attributable to the exploitation of exempt activities, see *Deductions and Expenses* in Chapter 3.

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

Volunteer labor. Any trade or business is excluded in which substantially all the work is performed for the organization without compensation. An example is a retail store operated by an exempt orphanage where unpaid volunteers perform substantially all the work in carrying on the business.

A volunteer fire company conducts weekly public dances. Since the work at the dances was done by unpaid volunteers, the income from the dances is not taxable as unrelated business taxable income. 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.

Convenience of members. Any trade or business is excluded that is carried on by an organization described in section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees. 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.

Certain activities of state fairs, trade shows, etc.. This discussion applies to ***public entertainment activities*** of organizations described in section 501(c)(3), 501(c)(4), or 501(c)(5), and to ***convention or trade show activities*** conducted by organizations that are described in section 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(6).

Public entertainment activity. Unrelated trade or business income does not include income received from 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.

Selling donated merchandise. Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions. A thrift shop that a tax-exempt organization operates and 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.

Local associations of employees. Any trade or business is excluded that is carried on by a local association of employees, described in section 501(c)(4), that was organized before May 27, 1969, and that consists of selling items of work-related clothes and equipment and items normally sold through vending machines, food dispensing facilities, or by snack bars for the convenience of the association's members at their usual place of employment. The exclusion applies only to sales of these items at the employees' usual place of employment; sales at other locations will continue to be treated as unrelated trade or business.

Bingo games. Certain bingo games are not included in the term ''unrelated trade or business.'' To qualify for this exclusion, the bingo game must be legal; it cannot be in violation of state or local law.

This exception for bingo games will not apply to bingo games conducted in a jurisdiction in which they are ''ordinarily carried out on a commercial basis.'' This means if for-profit organizations can regularly carry on bingo games in any part of the jurisdiction, the exclusion from unrelated trade or business does not apply. Jurisdiction is normally the entire state; however, in certain situations, local jurisdiction will control.

For example, tax-exempt organizations X and Y are organized under the laws of state N, which has a statutory provision 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 constitute an unrelated trade or business. However, X's bingo games conducted in county R outside of city S do not constitute an unrelated trade or business.

For a bingo game to qualify for this exclusion from unrelated trade or business, the wagers must be placed, the winners determined, and prizes or other property distributed in the presence of all persons placing wagers in that game.

Income from gambling activities other than bingo conducted by exempt organizations outside of North Dakota is generally treated as unrelated business income.

Exceptions. Section 513 provides exceptions to the general rule. Under section 513(a)(1), an exception applies if substantially all the work carrying on the trade or business activity is performed by unpaid volunteers.

Certain pole rentals. The term unrelated trade or business does not include engaging in 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 rights 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, after October 22, 1986, of low cost articles incidental to soliciting charitable contributions for tax-exempt organizations. 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 of the items if more than one is distributed) distributed to a single recipient in a tax year is not more than $5. This amount is adjusted annually for changes in cost of living. For 1994, the maximum cost of a low cost article is $6.40. 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 certain tax-exempt organizations described in section 501 is not included in the term unrelated trade or business. These organizations must be eligible to receive tax-deductible charitable contributions under sections 170(c)(2) and (3). This applies to exchanges or rentals after October 22, 1986.

3. 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 and Expenses

In order 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. To be ***directly connected*** with the conduct of unrelated business, deductions are allowable only if they have proximate and primary relationship to carrying on that unrelated trade or business except in certain cases of exploitation of exempt activities.

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 allocation method used must require that only expenses associated with profit-motivated activities can be deducted.

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, 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.

In another 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.

Expenses attributable to exploitation of exempt activities. In certain cases, gross income is derived from an unrelated trade or business that exploits an exempt activity. Generally, expenses, depreciation, and similar items attributable to the conduct of the exempt activity are not deductible in computing unrelated business taxable income 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, if the unrelated trade or business is the kind carried on for profit by taxable organizations and if the exempt activity is the type of activity normally conducted by taxable organizations in that business, the expenses, depreciation, and similar items attributable to the exempt activity qualify as directly connected with the conduct of the unrelated business to the extent that:

1) The expenses exceed the income (if any) derived from, or attributable to, the exempt activity; and
2) The allocation of the excess expenses to the unrelated business does not result in a loss from the unrelated trade or business.

Thus, the expenses are allocated first to the exempt activity, to the extent of income derived from, or attributable to, that activity. Any excess expense is allocated to the unrelated business, to the extent that the allocation does not result in a loss carryover or carryback to the unrelated business. Further, the excess expenses may not be allocated to any unrelated trade or business not exploiting the same exempt activity.

Advertising Income

Income realized by an exempt organization from the sale of advertising in a periodical is gross income from an unrelated trade or business activity involving the exploitation of an exempt activity, namely, the circulation and readership of the periodical developed by producing and distributing the readership content of that periodical.

Expenses, depreciation, and similar deductions that are attributable to producing and distributing the periodical are allowable as deductions directly connected with the unrelated advertising activity only to the extent they exceed subscription income.

Certain rules provide for determining how much unrelated business taxable income may be attributable to the sale of advertising in exempt organization periodicals. The same rules allow the unrelated business taxable income of two or more exempt organization periodicals to be determined on a consolidated basis.

Excess advertising costs. If the direct advertising costs of an exempt organization periodical exceed its gross advertising income, the excess can be deducted in determining the unrelated business taxable income from any unrelated trade or business activity that the exempt organization conducts.

Excess advertising income. If the gross advertising income of an exempt organization periodical exceeds the direct advertising costs, the expenses attributable to producing and distributing the readership content of the periodical will qualify as deductions directly connected with the unrelated advertising activity. The expenses can be deducted in computing unrelated business taxable income to the extent that these deductions exceed subscription income and do not result in a loss. Similarly, these expenses are not taken into account in computing the unrelated business taxable income of any unrelated trade or business activity other than the advertising activity.

If the periodical's circulation income equals or exceeds readership costs, the unrelated business taxable income attributable to the periodical is the excess of the gross advertising income over the direct advertising costs. However, if readership costs exceed circulation income, the unrelated business taxable income is any excess of the total income attributable to the periodical over the total periodical costs.

Gross periodical income. The total income from an exempt organization periodical is the sum of its gross advertising income and its circulation income. ***Gross advertising income*** means all the income from the unrelated advertising activities of an exempt organization periodical. ***Circulation income*** means all the income from the production, distribution, or circulation of a periodical (other than gross advertising income) including all amounts from the sale or distribution of the readership content of the periodical. When the right to receive an exempt organization periodical is associated with a membership or similar status in an organization for which dues, fees, or other charges are received (membership receipts), the circulation income includes a part of the membership receipts that are allocable to the periodical. Allocable membership receipts are the amount that would have been charged and paid if:

1) The periodical was that of 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 allocable membership receipts of an exempt organization periodical are determined as follows.

Subscription price charged to nonmembers. If 20% or more of the total circulation of a periodical is from sales to nonmembers, the subscription price charged nonmembers determines the price of the periodical for allocating membership receipts to the periodical.

Subscription price to members. If the condition in the last paragraph does not apply and the membership dues from 20% or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the reduction in membership dues for a member not receiving the periodical determines the price of the periodical for allocating membership receipts to the periodical.

Prorating membership receipts. When the conditions previously described do not apply, the share of the membership receipts allocated to the periodical equals the organization's membership receipts multiplied by a fraction. The numerator is the total periodical costs, and the denominator is those periodical costs plus the cost of the organization's other exempt 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 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 to the periodical 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. On the other hand, 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) and U's total circulation income is $32,000 ($27,000 plus $5,000).

Deductions attributable to exempt organization periodicals. Total periodical costs means the total deductions attributable to the periodical. These include the ***direct advertising costs*** and the ***readership costs.*** Deductions properly attributable to exempt activities other than publishing the periodical may not be allocated to the periodical. When expenses are attributable both to an exempt organization's 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.

Direct advertising costs of an exempt organization's periodical include all expenses, depreciation, and similar items of deduction directly connected with selling and publishing advertising. Allowable deductions in this category do not include deductions attributable to producing or distributing the periodical's readership content.

Examples of allowable deductions under this classification include agency commissions, and other direct selling costs such as transportation, travel expenses, office salaries, promotion and research expenses, and office overhead directly connected with the sale of advertising lineage in the periodical. Also included would be 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 to allowing these deductions as advertising costs, it also is necessary to determine 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 would include the part of the costs and other expenses of composition, press work, binding, mailing (including paper and wrappers used for mailing), and the bulk postage attributable to the advertising lineage of the publication .

In the absence of specific and detailed records, the deduction for 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 reasonabl e.

Readership costs of an exempt organization's periodical include expenses, depreciation, or similar items that are directly connected with the production and distribution of the readership content of the periodical and that otherwise would be allowable as a deduction in determining unrelated business taxable income if the production and distribution constituted an unrelated trade or business activity.

Consolidation. If the organization is subject to unrelated business income tax and publishes more than one periodical to produce income, it may treat all of them (but not less than all) as one in determining unrelated business taxable income from selling advertising. It treats the gross income from all the periodicals, and the deductions directly connected with them, on a consolidated basis. Consolidated treatment, once adopted, should be followed consistently and is binding, unless the consent of the Internal Revenue Service is obtained for a change in reporting.

Production of income. 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 the 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, Voluntary Employees' Beneficiary Associations, Etc.

Organizations described in section 501(c)(7) are ***social clubs*** organized for pleasure, recreation, and other nonprofitable purposes. Substantially all of their activities are for such purposes and no part of the earnings inure to the benefit of any private shareholder. Organizations described in section 501(c)(9) are ***voluntary employees' beneficiary associations*** that provide for the payment of life, sick, accident, or other benefits to the members of the associations or their dependents or designated beneficiaries, if no part of the net earnings of these associations inure (other than through such payments) to the benefit of any private shareholder or individual. Organizations described in section 501(c)(17) are ***trusts*** forming part of a plan providing for the payment of supplemental unemployment compensation benefits. Organizations described in section 501(c)(20) are domestic organizations whose exclusive function is to form part of a ***qualified group legal services plan.*** (Exemption under section 501(c)(20) expired for tax periods beginning after June 30, 1992)

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.*** Also, the dividends received deductions for corporations are not allowed in computing unrelated business taxable income, because they are not expenses incurred in the production of income.

Exempt function income is gross income from dues, fees, charges or similar items paid by members for the purposes for which exempt status was granted to the organization. Exempt function income also includes ***income that is set aside*** for qualified purposes.

Income that is set aside. The passive income of a social club, an employees' association, a supplemental unemployment benefit trust, and a group legal services organization generally is not taxed if it ***is 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, in the case of an employees' association, a supplemental unemployment benefit trust, or a group legal services organization, passive income is generally not taxed if it is set aside to provide for the payment of life, sick, accident, or other benefits. However, any amounts set aside that exceed the qualified asset account limit are unrelated business income. These three organizations figur e their asset account limits under section 419A. 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 includible in gross income. However, income set aside on or before the date, including extensions of time, for filing Form 990–T may, at the election of the organization, be treated as having been set aside in the tax year for which the return was filed, to the extent it would have been attributable to amounts that would have been includible in gross income for that year.

Nonrecognition of gain. Any gain on the sale of property used directly in performing an exempt function by a social club, voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust or group legal services organization that is used to purchase other property that is used directly in performing an exempt function by these organizations is recognized only to the extent that the sales price of the old property exceeds the cost of purchasing the new property. For the nonrecognition of this gain to apply, the purchase of the new property must be within 1 year before the date of sale of the old property or within 3 years after the date of sale.

For these purposes, the term ''sale of property''includes the destruction in whole or in part, theft, seizure, requisition, or condemnation of the property.

Special Rules for Veterans Organizations

Unrelated business taxable income of an organization that is exempt under section 501(c)(19) as a post or organization of past or present members of the Armed Forces of the United States, including an auxiliary unit or society thereof, or a trust or foundation established for the organization or post, does not include any amount attributable to payments for life, sick, accident, or health insurance for the organization's members or their dependents that is set aside for the payment of insurance benefits, reasonable costs of insurance administration, or for use exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Computing Unrelated Business Taxable Income

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

For example, if a payment the parties term rent is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization, or 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.

Modifications

The exclusions, deductions and other modifications required by special rules are as follows:

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 Commissioner 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. However, as discussed later in this publication, certain exceptions to these modifications apply in connection with debt-financed property (see chapter 4) and with controlled corporations (see *Other Modifications (Special Rules),* later in this chapter).

Income from lending securities. All amounts received in respect of a security loaned 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. However, see the exceptions in connection with debt-financed property (see chapter 4) and with controlled corporations (see *Other Modifications (Special Rules),* later in this chapter).

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, the amount of any payments for production, which are the equivalent of interest, are treated as interest and are excluded.

Rents. Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. In addition, rents from personal property leased with real property (mixed lease) are excluded if the rents attributable to the personal property are an incidental amount of the total rents received or accrued under the lease, as determined at the time the personal property is first placed in service. Rents from personal property generally will be considered incidental if the rent attributable to it does not exceed 10% of the total rents from all leased property. Deductions directly connected with excluded rents also are excluded.

A distinction between real property and personal property must be made in accordance with the general tax provisions of the Internal Revenue Code and the related regulations.

The rental exclusion does not apply to debt-financed property (see chapter 4) or property rented to a controlled organization (see *Other Modifications (Special Rules),* later in this chapter).

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.

Exception for mixed leases. In a mixed lease where the rent attributable to personal property is more than 50% of the total rent, determined at the time the personal property is first placed in service by the lessee, none of the rent (including the rent from real property) is excluded. Nor does the exclusion apply when the real or personal property rentals depend wholly or partly on the income or profits from leased property, other than an amount based on a fixed percentage or percentage of gross receipts or sales.

If separate leases are entered into for real and personal property and the properties have an integrated use (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.

If by placing additional or substitute personal property in service, the rent attributable to all the leased personal property increases by 100% or more, or if the lease is changed so that the rent changes (whether or not the amount of rented personal property changes), the rent attributable to personal property must be recomputed to determine whether the 10% exclusion or 50% exception applies. 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 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.

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.

Whether or not an organization is operated primarily to conduct fundamental research, as distinguished from applied research, is a question of fact to be determined in each case based on all the circumstances.

The term ***research*** does not include activities 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.

Commercially sponsored research constitutes scientific research carried on in the public interest if the results are published timely and made available for public information. However, when the publication is delayed beyond the time reasonably necessary to establish ownership rights, it is not in the public interest and therefore constitutes the conduct of an unrelated trade or business.

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.

Exclusions under this category do not apply to the gain derived from the sale or other disposition of debt-financed property.

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.

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 each 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 an officer of the Internal Revenue Service, no lower than the Regional Commissioner, 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. 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 profits 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, for the purposes of computing the net operating loss, the intervening 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 unrelated business income provisions for 1986 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 2001, regardless of whether the organization is subject to the unrelated business income tax in any of the intervening years.

Charitable contributions deductions. 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 the net operating loss and the net operating loss deduction.

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

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 for each parish, individual church, district, or other local unit a specific deduction limited to the lower of $1,000 or the gross income derived from an unrelated trade or business regularly carried on by 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.

Other Modifications (Special Rules)

Special rules for partnerships. An organization may have unrelated business income 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 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 that regularly engages in a trade or business, which is an unrelated trade or business with respect to the organization, the exempt entity 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 exceptions, limits, and additions discussed in this publication also apply to partnership income and are taken into account for this computation.

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 in 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.

Income from controlled organizations. 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 represent a trade or business or are regularly carried on). Under the provision for this situation, when a tax exempt organization controls another organization, 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.

The organization from which the interest, annuities, royalties, and rents are received is called the ***controlled organization*** and the exempt organization receiving these amounts is called the ***controlling organization.*** If the organization 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. 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.

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 controllin g 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, $4,000 of the rent paid by B will be included by A as net rental income in determining its unrelated business taxable income, 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 which 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 organizati on.

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.

Excess taxable income is the excess of the controlled organization's 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, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, 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

4.

Debt-Financed Property

Certain income from debt-financed property must be included by an exempt organization as unrelated business income. Thus, it must be determined whether property an organization holds will be treated as debt-financed property. This chapter describes debt-financed property and the exceptions from this classification. The property must be subject to an acquisition indebtedness sometime during the tax year to be debt-financed property. Acquisition indebtedness is discussed in Chapter 5.

For property that is debt financed, the determination of the amount of unrelated debt-financed income is discussed in Chapter 6.

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).

Property held to produce income includes rental real estate, tangible personal property, and corporate stock. Acquisition indebtedness is determined without regard to whether the property is debt-financed property. The ***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.

Buildings, acquired through assumption of outstanding mortgages by an exempt organization that restores, preserves, and exhibits buildings of historical and/or architectural significance, constitute debt-financed property when they are leased at fair rental value for uses that neither bear any relationship to the buildings' historical or architectural significance nor accommodate viewing by the general public.

Exceptions to Debt-Financed Property

Property related to certain exempt purposes. If substantially all (85% or more) of any property is used for an organization's exempt purposes, the property is not treated as debt-financed property. Related use does not include 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 total use of the property, 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.

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 outstanding principal debt throughout the year was $60,000. Thus, 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, 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:

Total rental income	$6,000
Deductions directly connected with rental income	$1,000
Debt/basis percentage ($30,000/$50,000)	60%
Rental income treated as gross income from 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

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 otherwise included in computing unrelated business taxable income.

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.

Property used in thrift shops is not treated as debt-financed property when it produces income from a trade or business that is excepted from the definition of an unrelated trade or business.

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 thrift shop operations.

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* in Chapter 3,
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 subject to a contract stating that the income is to be paid to that individual, to other persons, or to both, for a period not to exceed the life of the individual or individuals, in a transaction where the payments to the individual are not the proceeds of a sale or exchange of the property transferred, and if the remainder interest is payable to an exempt charitable organization, the property is not treated as debt-financed property by reason of the life income contract.

Neighborhood land rule. If an organization acquires real property mainly to use it 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 and if the intent to use the property for exempt purposes within 10 years is not abandoned. This provision is referred to as the neighborhood land rule.

Property is considered in the ***neighborhood*** of property that an organization owns and uses for its exempt purposes if the acquired property is contiguous with the exempt purpose property or would be contiguous except for an intervening road, street, railroad, stream, or similar property. If the acquired property is not contiguous with the exempt purpose property, it still may be in the same neighborhood if it is within one mile of the 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. The neighborhood land rule does not apply to property 10 years after its acquisition. Further, the rule applies after the first 5 years only if the organization satisfies the Internal Revenue Service 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 Internal Revenue Service CP:E:EO, P.O. Box 120 Franklin Station, Washington, DC 20224, for a ruling at least 90 days before the end of the 5th year after acquisition of the land. Under section 301.9100-1 of the Procedure and Administration Regulations, the Service may grant a reasonable extension of time for requesting the ruling if the organization can show good cause. For more information, contact the Internal Revenue Service.

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.

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 condition. A claim must be filed within one year after the close of the tax year in which the actual-use condition is satisfied. Interest rates on any overpayment are governed by the regulations.

The following example illustrates these conditions. Assume that without the neighborhood land rule, the property would be debt-financed property.

Example. In January 1987, Y, a calendar year exempt organization, acquired real property contiguous to other property that Y uses in furtherance of its exempt purpose. However, Y did not satisfy the Internal Revenue Service by January 1992 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 1992 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 1996, 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 1993 through 1995.

Further, Y also can file a claim for refund for 1992, 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 1997.

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 organizations must demonstrate the intent to use acquired property for exempt purposes is increased from 10 to 15 years, and
2) The requirement does not apply that specifies the acquired land 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, beginning 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 Service 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 (for the period after the first 5 years of the 15-year period) cannot establish to the satisfaction of the Service 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 to be 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 is includible, because of the distribution, as unrelated debt-financed income in the organization's gross income.

5.

Acquisition Indebtedness

This chapter defines the term ''acquisition indebtedness'' and gives examples of how income from property subject to acquisition indebtedness is treated for unrelated business income tax purposes.

Tax-exempt organizations that acquire or improve income-producing property with borrowed funds or with existing debt have acquisition indebtedness on the property. The income derived from the property is subject to the unrelated business income tax.

Income that is from debt-financed property, and is unrelated to the organization's exempt function, is treated as unrelated business income and is subject to the unrelated business income tax in the same proportion in which the property remains financed by debt.

Acquisition indebtedness means, for any debt-financed property, the outstanding amount of:

1) The principal debt incurred by the organization in acquiring or improving the property,
2) The principal debt incurred before acquiring or improving the property if the debt would not have been incurred without the acquisition or improvement, and
3) The principal debt incurred after the acquisition or improvement if the debt would not have been incurred without the acquisition or improvement and 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 is 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, formed 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 cost 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 held to be personally liable for payment of the mortgage.

The character of any item of income, gain, loss, deduction, or credit realized by the partnership and included in a partner's distributive share is determined as if the partner realized this item directly from the source from which the partnership realized it, and in the same manner.

Therefore, a part of X's income from the building is debt-financed income, and X figures its debt-basis percentage as follows. 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 with respect to acquiring the office building (one-third of $15 million).

Similarly, X's allocable part of the partnership's adjusted basis in the office building is $8 million (one-third of $24 million). Assuming no payment was made with respect to either debt and no adjustment was made to the basis, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for that year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for the year is 87.5% ($7 million/$8 million). (The debt-basis percentage is explained under *Computation of Debt/Basis Percentage,* in Chapter 6.)

Example 3. Debt that a wholly owned tax-exempt subsidiary title-holding company owes its parent labor union resulting from a loan to pay debts incurred to acquire two income-producing office buildings is not acquisition indebtedness.

The union advanced funds, from existing resources and without any borrowing, to the subsidiary to pay a debt the subsidiary owed to a third party, a debt previously incurred in acquiring the property. 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 interorganizational debt owed to the union by its wholly owned subsidiary title-holding company is not acquisition indebtedness.

Change in Use of Property

Property used for exempt purposes is not debt-financed property and thus debt on it is not acquisition indebtedness. However, if an organization converts this property to a nonexempt use that results in treatment as debt-financed property, the outstanding principal debt on the property is thereafter treated as acquisition indebtedness.

For example, 4 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 that would have had acquisition indebtedness except that the property was used for exempt purposes, and buys debt-financed property, any retained debt becomes acquisition indebtedness with respect to the newly acquired property, even though the original property was not debt-financed property.

For 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. It later sold the building for $1,000,000 without redeeming the pledge. It used the proceeds to buy an apartment building it rents to the general public. The debt of $400,000 is acquisition indebtedness with respect to the apartment building, even though the office building was not debt-financed property.

Property Acquired Subject to Mortgages

Generally, whenever property is acquired by purchase, gift, devise, bequest, or any other means subject to a mortgage, the outstanding principal debt secured by that mortgage is treated as acquisition indebtedness even though the organization did not assume or agree to pay the debt.

For 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).

Encumbered 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 property by gift 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 for property received by gift, bequest, or devise 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 *Annuities*).

Whether an organization has assumed and agreed to pay all or part of an indebtedness in order to acquire the property is determined by the facts and circumstances of each situation.

Extension of Debt

Extending, renewing, or refinancing a debt is considered to be a continuation of the old debt to the extent the outstanding principal of the old (existing) debt does not increase. When the principal of the modified obligation exceeds the outstanding principal of the old debt, the excess is treated as a separate debt.

Extension or renewal. In general, any change 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 an obligation:

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

Allocation. If the outstanding principal of a modified debt exceeds that of the unmodified debt, and only part of the refinanced debt is to be treated as acquisition indebtedness, the payments on the refinanced debt must be prorated between the old debt and the excess.

For 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 and the excess debt by $10,000.

Debt Incurred in Performing Exempt Purpose

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

Annuities

The 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 type of mortgage that is discussed under *Encumbered Property Acquired by Gift, Bequest, or Devise* earlier in this chapter) issued in exchange for the property acquired,
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 Internal Revenue Service. Your organization may request a ruling from the Internal Revenue Service on whether an obligation to make annuity payments is an acquisition indebtedness to the organization. To request a ruling, you must follow the provisions of Revenue Procedure 95-4, which is available at your local Internal Revenue office. (Provisions for waiver of the minimum funding standard that may apply to such an annuity are described in Revenue Procedure 94-41).

Securities Loans

Acquisition indebtedness does not include an obligation to return collateral security under a securities loan agreement (discussed under *Modifications* in chapter 3). This transaction is not treated as the borrowing by the exempt organization of the collateral furnished by the transferee. 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.

Real Property Acquired by Qualified Organization

In general, acquisition indebtedness does not include debt incurred by a qualified organization in acquiring or improving any real property. A qualified organization is a qualified trust under section 401(a), an educational organization described in section 170(b)(1)(A)(ii) and certain of its affiliated support organizations, and, for tax years after 1986, certain title-holding companies described in section 501(c)(25). However, this rule **does not apply** in the following six situations and indebtedness incurred to acquire or improve real property in these situations will be acquisition indebtedness:

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. See Note 1 at the end of this list also.
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). See Note 2 at the end of this list also.
4) The real property is acquired from, or is leased after the acquisition by the qualified trust to, a person related to the plan under which the trust is formed. For these purposes, related persons include:
   a) An employer who has employees covered by the plan,
   b) An owner with at least a 50% interest in such an employer or a corporation, partnership, or trust in which the employer has at least a 50% interest,
   c) A member of the family of any individual described above, or
   d) An officer, director, 10% or more shareholder, or highly compensated employee of a person described in (1) or (2). See Note 2 at the end of this list also.
5) The seller, a person related to the seller (under section 267(b) or section 707(b)), or a person related to the plan (as described in the fourth situation) provides financing of the transaction.
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 are not included in exceptions 1 and 2 and would, therefore, not give rise to acquisition indebtedness.

Note 2: For purposes of exceptions 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 insured by the Federal Housing Administration to finance the purchase, rehabilitation, or construction of housing for low or moderate income people.

6. Unrelated Debt-Financed Income

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

Unrelated business income includes unrelated debt-financed income from investment property. The investment income included is proportionate to the debt on the property. Various types of passive income are subject to this tax, 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

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 4).

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 *Tax Rates* in chapter 1.)

Debt-financed property transferred. 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, 1994, 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 1994 the only adjustment to basis is $20,000 for depreciation. Starting July 28, 1994, the organization pays $20,000 each month on the mortgage principal plus interest. The debt/basis percentage for 1994 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, 1994	$510,000
As of December 31, 1994	490,000
	$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, in a transaction when neither price nor debt is certain) the unadjusted basis and the initial acquisition indebtedness are determined as follows, unless the organization obtains the Commissioner'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 improvement. The initial acquisition indebtedness is the fair market value of the property or improvement on the date of acquisition or completion of improvement, less any down payment or other initial payment applied to the principal 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 deductions), except that:

1) The allowable deductions are subject to the modifications for computation of the unrelated business taxable income (discussed in chapter 3), 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 were debt-financed property. However, if only half of the building were treated as debt-financed property, the depreciation allowed as a deduction would be $5,000.

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. See *Deductions* in chapter 3. 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 of income (50% of $20,000), 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.

List of Tax Publications for Business Taxpayers

General Guides

1 ...... Your Rights as a Taxpayer
17 ..... Your Federal Income Tax (For Individuals)
225 .. Farmer's Tax Guide
334 .. Tax Guide for Small Business
509 .. Tax Calendars for 1995
553 .. Highlights of 1994 Tax Changes
910 .. Guide to Free Tax Services

Employer's Guides

15 ..... Employer's Tax Guide (Circular E)
51 ..... Agricultural Employer's Tax Guide (Circular A)
80 ..... Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)

Specialized Publications

349 .. Federal Highway Use Tax on Heavy Vehicles
378 .. Fuel Tax Credits and Refunds
463 .. Travel, Entertainment, and Gift Expenses
505 .. Tax Withholding and Estimated Tax
510 .. Excise Taxes for 1995
515 .. Withholding of Tax on Nonresident Aliens and Foreign Corporations
517 .. Social Security and Other Information for Members of the Clergy and Religious Workers
527 .. Residential Rental Property
533 .. Self-Employment Tax
534 .. Depreciation
535 .. Business Expenses
536 .. Net Operating Losses
537 .. Installment Sales
538 .. Accounting Periods and Methods
541 .. Tax Information on Partnerships
542 .. Tax Information on Corporations
544 .. Sales and Other Dispositions of Assets
551 .. Basis of Assets
556 .. Examination of Returns, Appeal Rights, and Claims for Refund
557 .. Tax-Exempt Status for Your Organization
560 .. Retirement Plans for the Self-Employed
561 .. Determining the Value of Donated Property
578 .. Tax Information for Private Foundations and Foundation Managers
583 .. Taxpayers Starting a Business
587 .. Business Use of Your Home
589 .. Tax Information on S Corporations
594 .. Understanding The Collection Process
597 .. Information on the United States-Canada Income Tax Treaty
598 .. Tax on Unrelated Business Income of Exempt Organizations
686 .. Certification for Reduced Tax Rates in Tax Treaty Countries
901 .. U.S. Tax Treaties
908 .. Tax Information on Bankruptcy
911 .. Tax Information for Direct Sellers
917 .. Business Use of a Car
924 .. Reporting of Real Estate Transactions to IRS
925 .. Passive Activity and At-Risk Rules
926 .. Employment Taxes for Household Employers
937 .. Employment Taxes
938 .. Real Estate Mortgage Conduits (REMICs) Reporting Information
946 .. How To Begin Depreciating Your Property
952 .. Sick Pay Reporting
953 .. International Tax Information for Business
960 .. Capital Construction Fund for Commercial Fishermen
1544 .. Reporting Cash Payments of Over $10,000
1546 .. How to use the Problem Resolution Program of the IRS

Spanish Language Publications

1SP .. Derechos del Contribuyente
556SP .. Revisión de las Declaraciones de Impuesto, Derecho de Apelación y Reclamaciones de Reembolsos
579SP .. Cómo Preparar la Declaración de Impuesto Federal
594SP .. Comprendiendo el Proceso de Cobro
850 .. English–Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service

Tax forms, publications and instructions listed on the order blank

You can get the following forms, schedules, and instructions at participating banks, post offices, or libraries.

Form 1040
Instructions for Form 1040 & Schedules
Schedule A for itemized deductions
Schedule B for interest and dividend income if over $400; and for answering the foreign accounts or foreign trusts questions
Schedule EIC for the earned income credit
Form 1040A
Instructions for Form 1040A & Schedules
Schedule 1 for Form 1040A filers to report interest and dividend income
Schedule 2 for Form 1040A filers to report child and dependent care expenses
Form 1040EZ
Instructions for Form 1040EZ

You can photocopy the items listed below (as well as those listed above) at participating libraries or order them from the IRS.

Schedule 3, Credit for the Elderly or the Disabled for Form 1040A Filers
Schedule C, Profit or Loss From Business
Schedule C-EZ, Net Profit From Business
Schedule D, Capital Gains and Losses
Schedule E, Supplemental Income and Loss
Schedule F, Profit or Loss From Farming
Schedule R, Credit for the Elderly or the Disabled
Schedule SE, Self-Employment Tax
Form 1040-ES, Estimated Tax for Individuals
Form 1040X, Amended U.S. Individual Income Tax Return
Form 2106, Employee Business Expenses
Form 2106-EZ, Unreimbursed Employee Business Expenses
Form 2119, Sale of Your Home
Form 2210, Underpayment of Estimated Tax by Individuals and Fiduciaries
Form 2441, Child and Dependent Care Expenses
Form 3903, Moving Expenses
Form 4562, Depreciation and Amortization
Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
Form 5329, Return for Additional Taxes Attibutable to Qualified Retirement Plans, Annuities, and Modified Endowment Contracts
Form 8283, Noncash Charitable Contributions
Form 8582, Passive Activity Loss Limitations
Form 8606, Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions
Form 8822, Change of Address
Form 8829, Expenses for Business Use of Your Home
Pub. 501, Exemptions, Standard Deduction, and Filing Information
Pub. 502, Medical and Dental Expenses
Pub. 505, Tax Withholding and Estimated Tax
Pub. 508, Educational Expenses
Pub. 521, Moving Expenses
Pub. 523, Selling Your Home
Pub. 525, Taxable and Nontaxable Income
Pub. 529, Miscellaneous Deductions
Pub. 550, Investment Income and Expenses
Pub. 554, Tax Information for Older Americans
Pub. 575, Pension and Annuity Income
Pub. 590, Individual Retirement Arrangements (IRAs)
Pub. 596, Earned Income Credit
Pub. 910, Guide to Free Tax Services (includes a list of publications)
Pub. 929, Tax Rules for Children and Dependents
Pub. 936, Limits on Home Mortgage Interest Deduction

How to Get IRS Forms and Publications

You can visit your local IRS office or order tax forms and publications from the IRS Forms Distribution Center listed for your state at the address on this page. Or, if you prefer, you can photocopy tax forms from reproducible copies kept at participating public libraries. In addition, many of these libraries have reference sets of IRS publications that you can read or copy.

Where To Mail Your Order Blank for Free Forms and Publications

If you live in:	Mail to:	Other locations:
Alaska, Arizona, California, Colorado, Hawaii, Idaho, Kansas, Montana, Nevada, New Mexico, Oklahoma, Oregon, Utah, Washington, Wyoming, Guam, Northern Marianas, American Samoa	Western Area Distribution Center Rancho Cordova, CA 95743-0001	**Foreign Addresses—** Taxpayers with mailing addresses in foreign countries should mail this order blank to either: Eastern Area Distribution Center, P.O. Box 25866, Richmond, VA 23286-8107, or Western Area Distribution Center, Rancho Cordova, CA 95743-0001, whichever is closer. Mail letter requests for other forms and publications to: Eastern Area Distribution Center, P.O. Box 25866, Richmond, VA 23286-8107.
Alabama, Arkansas, Illinois, Indiana, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Texas, Wisconsin	Central Area Distribution Center P.O. Box 8903 Bloomington, IL 61702-8903	**Puerto Rico—**Eastern Area Distribution Center, P.O. Box 25866, Richmond, VA 23286-8107.
Connecticut, Delaware, District of Columbia, Florida, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia	Eastern Area Distribution Center P.O. Box 85074 Richmond, VA 23261-5074	**Virgin Islands—**V.I. Bureau of Internal Revenue, Lockhart Gardens, No. 1-A Charlotte Amalie, St. Thomas, VI 00802

Detach at This Line

Order Blank

We will send you 2 copies of each form and 1 copy of each publication or set of instructions you circle. Please cut the order blank on the dotted line above and **be sure to print or type your name and address accurately on the bottom portion.**

Enclose this order blank in your own envelope and address your envelope to the IRS address shown above for your state.

To help reduce waste, please order only the forms, instructions, and publications you think you will need to prepare your return.

Use the blank spaces to order items not listed. If you need more space, attach a separate sheet of paper listing the additional forms and publications you may need.

You should either receive your order or notification of the status of your order within 7-15 work days after we receive your request.

1040	Schedule F (1040)	1040EZ	2441 & Instructions	8822 & Instructions	Pub. 505	Pub. 554	
Instructions for 1040 & Schedules	Schedule R (1040) & Instructions	Instructions for 1040EZ	3903 & Instructions	8829 & Instructions	Pub. 508	Pub. 575	
Schedules A&B (1040)	Schedule SE (1040)	1040-ES (1995) & Instructions	4562 & Instructions	Pub. 1	Pub. 521	Pub. 590	
Schedule C (1040)	1040A	1040X & Instructions	4868 & Instructions	Pub. 17	Pub. 523	Pub. 596	
Schedule C-EZ (1040)	Instructions for 1040A & Schedules	2106 & Instructions	5329 & Instructions	Pub. 334	Pub. 525	Pub. 910	
Schedule D (1040)	Schedule 1 (1040A)	2106-EZ & Instructions	8283 & Instructions	Pub. 463	Pub. 527	Pub. 917	
Schedule E (1040)	Schedule 2 (1040A)	2119 & Instructions	8582 & Instructions	Pub. 501	Pub. 529	Pub. 929	
Schedule EIC (1040A or 1040)	Schedule 3 (1040A) & Instructions	2210 & Instructions	8606 & Instructions	Pub. 502	Pub. 550	Pub. 936	

Name

Number and street

City or town | State | ZIP code