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Department of the Treasury

Internal Revenue Service

Publication 598
(Rev. March 2021)

Cat. No. 46598X

Tax on Unrelated Business Income of Exempt Organizations

DRAFT AS OF March 25, 2021

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Future Developments

The IRS has created a page on IRS.gov for information about Pub. 598, at *IRS.gov/Pub598*. Information about any future developments affecting Pub. 598 (such as legislation enacted after we release it) will be posted on that page.

What's New

- Mandatory electronic filing. Section 3101 of the Taxpayer First Act, (P.L. 116-25) requires tax-exempt organizations to electronically file information returns and related forms. This law affects tax-exempt organizations in tax years beginning after July 1, 2019. In 2020, the IRS continued to accept paper Forms 990-T pending conversion into electronic format. In 2021, the Form 990-T is being updated and e-filing is required for tax year 2020 filings. The IRS expects e-filing to be available beginning in February 2021. The IRS will announce the specific dates when the programming comes online. See the Instructions for Form 990-T, *When, Where, and How To File,* for more information.
- Final regulations issued. Section 512(a)(6) requires a tax-exempt organization with more than one unrelated trade or business to compute unrelated business taxable income (UBTI), including any NOL deduction, separately for each trade or business. Final regulations were published in the Federal Register on December 2, 2020, that provide guidance on how an exempt organization determines if it has more than one unrelated trade or business, and, if so, how the exempt organization calculates unrelated business taxable income. T.D. 9933, 85 Fed. Reg. 77952 (Dec. 2, 2020). The final regulations are applicable to tax years beginning on or after December 2, 2020. In addition, an exempt organization may choose to apply the final regulations under section 512(a)(6) to tax years beginning on or after January 1, 2018, and before December 2, 2020. Alternatively, an exempt

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organization may rely on a reasonable, good-faith interpretation of section 512(a)(6) for such tax years. For this purpose, a reasonable good faith interpretation includes the methods of aggregating or identifying separate trades or businesses provided in Notice 2018-67 or the proposed regulations published April 24, 2020 (85 Fed. Reg. 23172). See T.D. 9933 for more details.

- Form 990-T has been redesigned for tax year 2020. Schedule M (Form 990-T) has been replaced with Schedule A. Each unrelated trade or business of an organization is reported on a separate Schedule A. At the organization's discretion, each separate trade or business may be classified by a 2-digit North American Industrial Classification System (NAICS) code. See Regulations section 1.512(a)-6(b)(1). The Instructions for Form 990-T provide 6-digit Business Activity Codes for investment and other activities not represented in NAICS.
- Organizations with more than one unrelated trade or business must compute unrelated business taxable income (UBTI), including for the purpose of determining any net operating loss deduction, separately with respect to each such trade or business. See Regulations section 1.512(a)-6 for more information.
- Retroactive repeal of section 512(a)(7). P.L. 116-94 retroactively repealed the section 512(a)(7), which required exempt organizations to increase their unrelated business taxable income for expenses incurred to provide certain benefits, including qualified transportation fringes. If your organization reported and paid tax on such amounts included in unrelated business taxable income for tax years 2017 or 2018 and you want to claim a refund, file an amended Form 990-T.
- Net operating loss (NOL) carryback. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) amended section 172 provides for carryback of any net operating loss arising in a tax year beginning after 2017 and before 2021 to each of the 5 tax years preceding the tax year of the NOL. Taxpayers may elect to waive the carryback period for NOLs arising in those years. To elect to waive the carryback period for an NOL arising in a tax year beginning in 2018 or 2019, attach a statement electing the carryback waiver to your return for the first tax year ending after March 27, 2020. For more information, see Rev. Proc. 2020-24. If you incurred an NOL in a tax year beginning in 2018 or 2019, you can file an amended return, Form 990-T, to carryback the NOL. See Pub. 536 for more information.
- The maximum cost of a low-cost article, for organizations eligible to receive charitable contributions, was increased to $11.20 for 2020. See *Distribution of low-cost articles*, later.
- The annual limit on associate member dues received by an agricultural or horticultural organization not treated as gross income was increased to $171 for 2020. See *Exception* under *Dues of Agricultural Organizations and Business Leagues*, later.

Introduction

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

However, if an exempt organization regularly carries on one or more trades or businesses not substantially related to the organization's exempt purpose, except that conducting the trade or business provides funds to carry out the exempt purpose, the organization is subject to tax on its income from the unrelated trade(s) or business(es).

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

1. Which organizations are subject to the tax (chapter 1),
2. What the requirements are for filing a tax return (chapter 2),
3. What an unrelated trade or business is (chapter 3), and
4. How to figure unrelated business taxable income (chapter 4).

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

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

- ❑ **990-T** Exempt Organization Business Income Tax Return
- ❑ **Schedule A (990-T)** Unrelated Business Taxable Income From an Unrelated Trade or Business

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Tax questions. If you have tax questions not answered by the publication, check IRS.gov and *How To Get Tax Help* at the end of this publication.

1. Organizations Subject to the Tax

The tax on unrelated business income applies to most organizations exempt from tax under section 501(a). These organizations include charitable, religious, scientific, and other organizations described in section 501(c), as well as employees' trusts forming part of pension, profit-sharing, and stock bonus plans described in section 401(a).

In addition, the following are subject to the tax on unrelated business income.

- Individual retirement arrangements (IRAs), including traditional IRAs, Roth IRAs, simplified employee pensions (SEP-IRAs), and savings incentive match plans for employees (SIMPLE IRAs).
- State and municipal colleges and universities.
- Qualified state tuition programs described in section 529.
- Qualified ABLE programs described in section 529A.
- Medical savings accounts (MSAs) described in section 220(d).
- Coverdell savings accounts described in section 530.

U.S. instrumentalities. A corporation that is a U.S. instrumentality described in section 501(c)(1) isn't subject to the tax on unrelated business income if the corporation is organized under an Act of Congress and, under the Act, is exempt from federal income taxes.

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

The tax is on the unrelated business income of both the universities and colleges themselves and on their wholly owned or controlled tax exempt subsidiary organizations. It is immaterial whether the business is conducted by the university or by a separately incorporated wholly owned or controlled subsidiary. If the business activity is unrelated, the income in both instances will be subject to the tax. If the primary

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purpose of a wholly owned or controlled subsidiary is to operate or conduct any unrelated trade or business (other than holding title to property and collecting income from it), the subsidiary isn't an exempt organization, and this rule doesn't apply.

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

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

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

2.

The Tax and Filing Requirements

All organizations subject to the tax on unrelated business income, except the exempt trusts described in section 511(b)(2), are taxable at corporate rates on that income. All exempt trusts subject to the tax on unrelated business income that, if not exempt, would be taxable as trusts are taxable at trust rates on that income. However, an exempt trust may not claim the deduction for a personal exemption that is normally allowed to a trust.

The tax is imposed on the organization's unrelated business taxable income (UBTI) (described in chapter 4). Under section 512(a)(6), an organization that conducts more than one unrelated trade or business calculates its UBTI as the sum of the UBTI calculated separately for each unrelated trade or business, and when calculating this sum, the UBTI from any of the separate trades or businesses can't be less than zero. The tax computed on the total UBTI can be reduced by any applicable tax credits, including the general business credits (such as the investment credit) and the foreign tax credit.

Returns and Filing Requirements

Mandatory electronic filing of Form 990-T started in February 2021. Limited exceptions apply. See the Instructions for Form 990-T for more information. The obligation to file Form 990-T is in addition to the obligation to file any other required return or notice.

Form 990-T is required if the sum of the organization's gross income from all unrelated businesses is $1,000 or more. An exempt organization files a single Form 990-T. The organization reports the income and expenses for each of its unrelated businesses on a separate Schedule A (Form 990-T) attached to the Form 990-T. See Regulations section 1.512(a)-6 for information about how to identify separate unrelated trades or businesses.

Each organization must file a separate Form 990-T, except section 501(c)(2) title-holding corporations and organizations receiving their earnings that file a consolidated return under section 1501.

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

When to file. The Form 990-T of an employees' trust described in section 401(a), an IRA (including a traditional, SEP, SIMPLE, Roth, or Coverdell IRA), or an MSA must be filed by the 15th day of the 4th month after the end of its tax year. The Form 990-T of any other exempt organization must be filed by the 15th day of the 5th month after the end of its tax year. If the due date falls on a Saturday, Sunday, or legal holiday, the return is due by the next business day.

Extension of time to file. Use Form 8868, Application for Automatic Extension of Time To File an Exempt Organization Return, to request an automatic 6-month extension of time to file Form 990-T.

Public Inspection Requirements of Section 501(c)(3) Organizations. Under section 6104(d), a section 501(c)(3) organization that has gross income from an unrelated trade or business of $1,000 or more must make its Form 990-T return (including amended returns) available for public inspection. See the Instructions for Form 990-T for information about attachments and related forms that are disclosable as part of the return.

TIP *A section 501(c)(3) organization filing the Form 990-T only to request a credit for certain federal excise taxes paid doesn't have to make the Form 990-T available for public inspection.*

Payment of Tax

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

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

All tax-exempt organizations should use Form 990-W (Worksheet), to figure their estimated tax.

Tax due with Form 990-T. Any tax due with Form 990-T must be paid in full when the return is filed, but no later than the date the return is due (determined without extensions).

Federal Tax Deposits Must be Made by Electronic Funds Transfer

Electronic Deposit Requirement. The organization must deposit all depository taxes (such as employment tax, excise tax, and corporate income tax) electronically. Generally, electronic fund transfers are made using the Electronic Federal Tax Payment System (EFTPS). For more information about EFTPS or to enroll in EFTPS, visit the EFTPS website at *EFTPS.gov*, or call 1-800-555-4477, 1-800-733-4829 (TDD), or 1-800-244-4829 (Spanish). You can also get Pub. 966, Electronic Federal Tax Payment System: A Guide to Getting Started.

Depositing on time. For EFTPS deposits to be made timely, the organization must initiate the deposit by 8 p.m. Eastern time the day before the deposit is due.

Same-day wire payment option. If you fail to initiate a deposit transaction on EFTPS by 8 p.m. Eastern time the day before the date a deposit is due, you can still make your deposit on time by using the Federal Tax Application (FTA), a same-day federal tax payment system that works in conjunction with EFTPS. Make arrangements with your financial institution ahead of time, noting the institution's availability, deadlines, and costs, if you believe you would ever need the same-day wire payment option. To learn more, visit *IRS.gov/SameDayWire* and

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also download the Same-Day Payment Worksheet.

Timeliness of deposits. The IRS uses business days to determine the timeliness of deposits. Business days are any day that isn't a Saturday, Sunday, or legal holiday in the District of Columbia. See Pub. 583, Starting a Business and Keeping Records.

CAUTION *If the organization owes tax and is filing a paper Form 990-T, don't include the payment with the tax return. Instead, use EFTPS.*

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3. Unrelated Trade or Business

Unrelated business income is the income from a trade or business regularly conducted by an exempt organization and not substantially related to the performance by the organization of its exempt purpose or function. Use by the organization, of the profits derived from this activity, does not, alone, make the activity substantially related to the performance by the organization of its exempt purpose or function.

Certain trade or business activities aren't treated as an unrelated trade or business. See *Excluded Trade or Business Activities*, later.

Trade or business. The term "trade or business" generally includes any activity conducted for the production of income from selling goods or performing services. An activity must be conducted with intent to make a profit to constitute a trade or business. An activity doesn't lose its identity as a trade or business merely because it is conducted within a larger group of similar activities that may or may not be related to the exempt purposes of the organization.

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

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

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

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

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

Also in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the following principles apply.

Selling of products of exempt functions. Ordinarily, selling products that result from the performance of exempt functions isn't 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 (its exempt function), selling articles made by these persons as part of their rehabilitation training is not an unrelated trade or business.

However, if a completed product resulting from an exempt function is used or exploited in further business activity beyond what is reasonably appropriate or necessary to dispose of it as is, the activity is an unrelated trade or business. For example, if an exempt organization maintains an experimental dairy herd for scientific purposes, the sale of milk and cream produced in the ordinary course of operation of the project isn't an unrelated trade or business. But if the organization uses the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the sale of these products is an unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

Dual use of assets or facilities. If an asset or facility necessary to the conduct of exempt functions is also used in commercial activities, its use for exempt functions doesn't, by itself, make the commercial activities a related trade or business. The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of exempt purposes.

For example, a museum has a theater auditorium designed for showing educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and operates continuously while the museum is open to the public. If the organization also operates the theater as a motion picture theater for the public when the museum is closed, the activity is an unrelated trade or business.

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

Exploitation of exempt functions. Exempt activities sometimes create goodwill or other intangibles that can be exploited in a commercial way. When an organization exploits such an intangible in commercial activities, the fact that the income depends in part upon an exempt function of the organization doesn't make the commercial activities a related trade or business. Unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business.

For the treatment of expenses attributable to the exploitation of exempt activities, see *Deductions* in chapter 4.

Examples

The following are examples of activities that were determined to be (or not to be) unrelated trades or businesses using the definitions and principles just discussed.

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

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

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

Business league's parking and bus services. The exempt purpose of a business league is to retain and stimulate trade in a downtown area that has inadequate parking facilities. The organization operates, as an insubstantial part of its activities, a park-and-shop plan.

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.

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 doesn't further its exempt purpose. Therefore, operating the park-and-shop plan is an unrelated trade or business.

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

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 if there is a intent to make a profit.

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

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

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

Exceptions. Administrative services provided by an organization whose exempt activities may include the provision of insurance benefits, such as fraternal beneficiary societies, voluntary employees beneficiary associations, and labor organizations, are generally not an unrelated trade or business.

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

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

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

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

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

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

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

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

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

The museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards with printed reproductions of artworks contributes importantly to the achievement of the museum's exempt educational purposes by enhancing public awareness, interest, and appreciation of art. The cards may encourage more people to visit the museum itself to share in its educational programs. The fact that the cards are promoted and sold in a commercial manner at a profit and in competition with commercial greeting card publishers doesn't alter the fact that the activity is related to the museum's exempt purpose. Therefore, these sales activities aren't an unrelated trade or business.

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

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

The shop also rents originals or reproductions of paintings contained in its collection. All of its reproductions are imprinted with the name of the artist, the title or subject matter of the work from which it is reproduced, and the museum's name.

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Each line of merchandise must be considered separately to determine if sales are related to the exempt purpose.

The sale and rental of reproductions and copies of works from the museum's own collection and reproductions of artistic works not owned by the museum contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art. The same is true for the sale of literature relating to art. Therefore, these sales activities aren't an unrelated trade or business.

On the other hand, the sale (if they intend to make a profit) of scientific books and souvenir items of the city where the museum is located has no causal relationship to art or to artistic endeavor and, therefore, doesn't contribute importantly to the accomplishment of the museum's exempt educational purposes. Even though selling some of these items could, in a different context, be related to the exempt educational purpose of a different exempt educational organization doesn't change this conclusion. Additionally, the sale of these items doesn't lose its character as an unrelated trade or business merely because the museum also sells articles that contribute importantly to the accomplishment of its exempt function. Therefore, these sales by the museum in this example are an unrelated trade or business.

Nonpatient laboratory testing. Nonpatient laboratory testing performed by a tax-exempt teaching hospital on specimens needed for the conduct of its teaching activities isn't an unrelated trade or business. However, laboratory testing performed by a tax-exempt non-teaching hospital on referred specimens from private office patients of staff physicians is an unrelated trade or business if these services are otherwise available in the community.

Pet boarding and grooming services. An exempt organization, organized and operated for the prevention of cruelty to animals, receives unrelated business income from providing pet boarding and grooming services for the general public. These activities don't contribute importantly to its purpose of preventing cruelty to animals.

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

The publication of ordinary commercial advertising doesn't 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 doesn't 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 doesn't constitute an unrelated trade or business.

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

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

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

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

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

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

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

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

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

Sales of hearing aids. A tax-exempt hospital, whose primary activity is rehabilitation, sells hearing aids to patients. This activity is an essential part of the hospital's program to test and evaluate patients with hearing deficiencies and contributes importantly to its exempt purpose. The hearing aid sales aren't an unrelated trade or business.

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

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

In both situations, the organization's exempt purpose is the advancement of education. Furnishing tennis facilities in the manner described doesn't further that exempt purpose. These activities are unrelated trades or businesses. However, in the second situation the income derived from the leasing of the property may be excluded from UBTI as rent from real property. See *Rents* under *Exclusions* in chapter 4.

School handicraft shop. An exempt vocational school operates a handicraft shop that sells articles made by students in their regular courses of instruction. The students are paid a percentage of the sales price. In addition, the shop sells products made by local residents who make articles at home according to the

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shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that they meet desired standards of style and quality. Although many local participants are former students of the school, any qualified person may participate in the program. The sale of articles made by students doesn't 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.

Selling endorsements. 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 doesn't contribute importantly to the accomplishment of any purpose for which exemption is granted to the organization. Accordingly, the sale of endorsements is an unrelated trade or business.

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

Leasing of the stadium is an unrelated trade or business. In addition, the substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental of space for occupancy only. Therefore, the income from this lease is rent from real property and unrelated business taxable income.

Sponsoring entertainment events. An exempt university has a regular faculty and a regularly enrolled student body. During the school year, the university sponsors the appearance of professional theater companies and symphony orchestras that present drama and musical performances for the students and faculty members. Members of the general public also are admitted. The university advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. Although the presentation of the performances makes use of an intangible generated by the university's exempt educational functions—the presence of the student body and faculty—such drama and music events contribute importantly to the overall educational and cultural functions of the university. Therefore, the activity isn't an unrelated trade or business.

Travel tour programs. Travel tour activities that are a trade or business are an unrelated trade or business if the activities aren't substantially related to the purpose for which tax exemption was granted to the organization.

Example 1. A tax-exempt university alumni association provides a travel tour program for its members and their families. The organization works with various travel agencies and schedules approximately ten tours a year to various places around the world. It mails out promotional material and accepts reservations for fees paid by the travel agencies on a per-person basis.

The organization provides an employee for each tour as a tour leader. There is no formal educational program conducted with these tours, and they don't differ from regular commercially operated tours (if there is a intent to make a profit).

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

Example 2. A tax-exempt organization formed for the purpose of educating individuals about the geography and the culture of the United States provides study tours to national parks and other locations within the United States. These tours are conducted by teachers and others certified by the state board of education. The tours are primarily designed for students enrolled in degree programs at state educational institutions but are open to all who agree to participate in the required study program associated with the tour taken. A tour's study program consists of instruction on subjects related to the location being visited on the tour. Each tour group brings along a library of material related to the subjects being studied on the tour. During the tour, 5 or 6 hours per day are devoted to organized study, preparation of reports, lectures, instruction, and recitation by the students. Examinations are given at the end of each tour. The state board of education awards academic credit for tour participation. Because these tours are substantially related to the organization's exempt purpose, they aren't an unrelated trade or business.

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

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

Excluded Trade or Business Activities

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

Gaming. In general, games of chance do not further an exempt purpose. An exempt organization that generates revenue from the conduct of activities will be operating an unrelated trade or business, unless a exception applies. The exceptions to the general rule (that gaming does not usually further an exempt purpose) include organizations whose exempt purposes include social or recreational activities. For these organizations, gaming itself may further an exempt purpose.

More information about gaming activities by exempt organizations can be found in Publication 3079, Tax-Exempt Organizations and Gaming.

Bingo games. Bingo games may qualify for a specific exclusion from the definition of unrelated trade or business. To qualify for this exclusion, the bingo game must meet the following requirements.

1. It meets the legal definition of bingo.
2. It is legal where it is played.
3. It is played in a jurisdiction where bingo games aren't regularly conducted by for-profit organizations.

Gambling activities other than bingo. Games of chance conducted by an exempt organization may avoid being treated as an unrelated trade or business if they are:

- Conducted with substantially all volunteer labor,
- Qualified public entertainment activities, and
- Games of chance conducted in North Dakota.

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

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

Legal where played. This exclusion applies only if bingo is legal under the laws of the jurisdiction where it is conducted. The fact that a jurisdiction's law that prohibits bingo is rarely enforced or is widely disregarded doesn't make the conduct of bingo legal for the exception and is therefore an unrelated trade or business.

No for-profit games where played. This exclusion applies only if for-profit organizations can't regularly conduct bingo games in any part of the same jurisdiction. Jurisdiction is normally

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the entire state; however, in certain situations, local jurisdiction will control.

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

See Pub. 3079, for more detailed information.

Convenience of members. A trade or business conducted by a 501(c)(3) organization or by a state college or university primarily for the convenience of its members, students, patients, officers, or employees isn't an unrelated trade or business. For example, a laundry operated by a college for the purpose of laundering dormitory linens and students' clothing isn't an unrelated trade or business.

Convention or trade show activity. An unrelated trade or business doesn't include 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 conducted 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 isn't an unrelated trade or business even if 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.

Certain Internet activities conducted by a trade association described in section 501(c)(6) will be considered qualified convention and trade show activity if conducted on a special supplementary section of the association's website in conjunction with a trade show conducted by the association. The trade show itself must be a qualified convention and trade show activity. The supplementary section of the website must be ancillary to, and serve to augment and enhance, the trade show, as when it makes available the same information available at the trade show and is available only during a time period that coincides with the time period that the trade show is in operation. Conversely, Internet activities that aren't conducted in conjunction with a qualified convention and trade show activity and that don't augment and enhance the trade show can't themselves be qualified convention and trade show activity.

Distribution of low-cost articles. The term "unrelated trade or business" doesn't include activities relating to the distribution of low-cost articles incidental to soliciting charitable contributions. This applies to organizations described in section 501 that are eligible to receive charitable income tax deductible contributions.

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

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

An article is considered low cost if the cost of an item (or the aggregate costs if more than one item) distributed to a single recipient in a tax year isn't more than $11.20 (in 2020), indexed annually for inflation. The cost of an article is the cost to the organization that distributes the item or on whose behalf it is distributed.

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

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

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

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

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

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

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

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

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

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

Qualified sponsorship activities. Receiving qualified sponsorship payments isn't an unrelated trade or business, and the payments aren't subject to unrelated business income tax.

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

For example, if, in return for receiving a sponsorship payment, an organization

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promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event, the payment is a qualified sponsorship payment and isn't subject to the unrelated business income tax.

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

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

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

Advertising. A payment isn't a qualified sponsorship payment if, in return, the organization advertises the sponsor's products or services. For information on the treatment of payments for advertising, see *Exploitation of Exempt Activity—Advertising Sales* in chapter 4.

Advertising includes:

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

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

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

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

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

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

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

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

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

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

4. Unrelated Business Taxable Income

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The term "unrelated business taxable income" (UBTI) generally means the gross income derived from any unrelated trade or business regularly conducted by the exempt organization, less the deductions directly connected with carrying on the trade or business. Section 512(a)(6) requires an organization that regularly carries on two or more unrelated business activities to calculate its unrelated business taxable income, including for purposes of determining any net operating loss deduction, separately with respect to each such trade or business. The UBTI of the organization is the sum of the UBTI computed from each separate unrelated trade or business. For the purpose of this sum, the UBTI from any of the unrelated trades or businesses can't be less than zero. See Regulations section 1.512(a)-6 for more information.

In computing UBTI, gross income and deductions are subject to the modifications and special rules explained in this chapter. Whether a particular item of income or expense falls within any of these modifications or special rules must be determined by all the facts and circumstances in each specific case. For example, if the organization received a payment termed rent that is in fact a return of profits by a person operating the property for the benefit of the organization, or that is a share of the profits retained by the organization as a partner or joint venturer, the payment isn't within the income exclusion for rents, discussed later under *Exclusions*.

Income

Generally, unrelated business income is taxable, but there are exclusions and special rules that must be considered when figuring the income.

Exclusions

The following types of income (and deductions directly connected with the income) are generally excluded when figuring UBTI.

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

Exception for insurance activity income of a controlled foreign corporation. This

exclusion doesn't apply to income from certain insurance activities of an exempt organization's controlled foreign corporation. The income isn't excludable dividend income, but instead is UBTI to the extent it would be so treated if the exempt organization had earned it directly. Certain exceptions to this rule apply. For more information, see section 512(b)(17).

Other exceptions. This exclusion doesn't apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property*, later), or to certain rents, royalties, interest or annuities received from a controlled corporation (discussed under *Income From Controlled Organizations*, later).

Income from lending securities. Payments received with respect to a security loan are excluded in computing UBTI only if the loan is made under an agreement that:

1. Provides for the return to the exempt organization of securities identical to the securities loaned,
2. Requires payments to the organization 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. Doesn't reduce the organization's risk of loss or opportunity for gain on the securities,
4. Contains reasonable procedures to implement the obligation of the borrower to furnish collateral to the organization with a fair market value each business day during the period of the loan in an amount not less than the fair market value of the securities at the close of the preceding business day, and
5. Permits the organization to terminate the loan 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 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, are excluded in computing UBTI.

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. Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily considered royalties. However, royalties don't include payments for personal services. Therefore, payments for personal appearances and interviews aren't excluded as royalties and must be included in figuring UBTI.

Unrelated business taxable income doesn't 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 doesn't 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 aren't 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 UBTI. To the extent they are treated as loans, any payments for production that are the equivalent of interest are treated as interest and are excluded.

Exceptions. This exclusion doesn't apply to debt-financed income (discussed under *Income From Debt-Financed Property*, later) or to royalties received from a controlled corporation (discussed under *Income From Controlled Organizations*, later).

Rents. Rents from real property, including elevators and escalators, are excluded in computing UBTI. Rents from personal property aren't excluded. However, special rules apply to "mixed leases" of both real and personal property.

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

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

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

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

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

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

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

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

Other exceptions. This exclusion doesn't apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property*, later), or to interest, annuities, royalties and rents received from a controlled corporation (discussed under *Income From Controlled Organizations*, later), or investment income (dividends, interest, rents, etc.) received by organizations described in sections 501(c)(7), 501(c)(9), and 501(c)(17). See *Special Rules for Social Clubs, VEBAs, and SUBs*, discussed later, for more information.

Income from research. A tax-exempt organization may exclude income from research grants or contracts from UBTI. 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, or a state or any of its political subdivisions is excluded when computing UBTI.

For a college, university, or hospital, all income from research, whether fundamental or applied, is excluded in computing UBTI.

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 is excluded in computing UBTI.

The term research, for this purpose, doesn't include activities of a type normally conducted 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 doesn't include research conducted for the primary purpose of commercial or industrial application.

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Gains and losses from disposition of property. Also excluded from UBTI 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 includible 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.

Lapse or termination of options. Any gain from the lapse or termination of options to buy or sell securities is excluded from UBTI. The exclusion applies only if the option is written in connection with the exempt organization's investment activities. Therefore, this exclusion isn't 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.

Exception. This exclusion doesn't apply to unrelated debt-financed income, discussed later under *Income From Debt-Financed Property*.

Gain or loss on disposition of certain brownfield property. Gain or loss from the qualifying sale, exchange, or other disposition of a qualifying brownfield property (as defined in section 512(b)(19)(C)), which was acquired by the organization after December 31, 2005 and before January 1, 2011, is excluded from UBTI and is excepted from the debt-financed rules. See sections 512(b)(19) and 514(b)(1)(E).

Income from services provided under federal license. There is a further exclusion from UBTI of income from a trade or business conducted by a religious order or by an educational organization maintained by the order.

This exclusion applies only if the following requirements are met.

1. The trade or business must have been operated by the order or by the institution before May 27, 1959.
2. The trade or business must provide services under a license issued by a federal regulatory agency.
3. More than 90% of the net income from the business for the tax year must be devoted to religious, charitable, or educational purposes that constitute the basis for the religious order's exemption.
4. The rates or other charges for these services must be fully competitive with the rates or other charges of similar taxable businesses. Rates or other charges for these services will be considered as fully competitive if they are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

Exception. This exclusion doesn't apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property*, later).

Member income of mutual or cooperative electric companies. Income of a mutual or cooperative electric company described in section 501(c)(12) that is treated as member income under subparagraph (H) of that section is excluded from UBTI.

Dues of Agricultural Organizations and Business Leagues

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

Exception. Associate member dues received by an agricultural or horticultural organization aren't treated as gross income from an unrelated trade or business, regardless of their purpose, provided the associate member dues do not exceed an annual limit, which is indexed for inflation. The limit on dues paid by an associate member is $171 in 2020.

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

Deductions

To qualify as allowable deductions in computing UBTI, the expenses, depreciation, and similar items must generally be allowable income tax deductions that are directly connected with carrying on the unrelated trade or business to which they relate. They can't be directly connected with excluded income.

For an exception to the "directly connected" requirement, see *Charitable contributions deduction*, under *Modifications,* later.

Directly Connected

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

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

For example, salaries of personnel employed full-time to conduct 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 conduct exempt functions and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis. The part of an item allocated to the unrelated trade or business is proximately and primarily related to that business and is allowable as a deduction in computing UBTI if the expense is otherwise an allowable income tax deduction.

An exempt organization with more than one unrelated trade or business likewise allocates deductions between separate unrelated trades or businesses using the reasonable basis standard.

Example 1. A school recognized as a tax-exempt organization contracts with an individual to conduct a summer tennis camp. The school provides the individual with tennis courts, housing, and dining facilities, and personnel to maintain and operate them. The contracted individual hires the instructors, recruits campers, and provides supervision of the tennis camp. The income the school receives from the individual under the contract from this activity for the use of its facilities and personnel is from a dual use of the facilities and personnel, not from conducting an educational activity. The school, in computing its UBTI, may deduct an allocable part of the expenses attributable to the facilities and personnel it makes available under the contract.

Example 2. 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 his time to the unrelated business. To figure the organization's UBTI, a deduction of $9,000 ($90,000 × 10%) is allowed for the salary paid to its president.

Expenses attributable to exploitation of exempt activities. Generally, expenses, depreciation, and similar items attributable to the conduct of an exempt activity aren't deductible in computing UBTI from an unrelated trade or business that exploits the exempt activity. (See *Exploitation of exempt functions* under *Not substantially related* in chapter 3.) This is because they don't have a proximate and primary relationship to the unrelated trade or business, and therefore, they don't qualify as directly connected with that business.

Exception. Expenses, depreciation, and similar items may be treated as directly connected with the conduct of the unrelated business if all the following conditions are met.

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1. The unrelated business exploits the exempt activity.
2. The unrelated business is a type normally conducted for profit by taxable organizations.
3. The exempt activity is a type normally conducted by taxable organizations in carrying on that type of business.

The amount treated as directly connected is the smaller of:

1. The excess of these expenses, depreciation, and similar items over the income from, or attributable to, the exempt activity; or
2. The gross unrelated business income reduced by all other expenses, depreciation, and other items that are actually directly connected.

The application of these rules to an advertising activity that exploits an exempt publishing activity is explained next.

Exploitation of Exempt Activity—Advertising Sales

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

Figuring UBTI. The UBTI of an advertising activity is the amount shown in the following chart.

IF gross advertising income is . . .	THEN UBTI is . . .
more than direct advertising costs	the excess advertising income, reduced (but not below zero) by the excess, if any, of readership costs over circulation income.
equal to or less than direct advertising costs	zero. Circulation income and readership costs aren't taken into account.

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

Periodical Income

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

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

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

1. The periodical was published by a taxable organization,
2. The periodical was published for profit, and
3. The member was an unrelated party dealing with the taxable organization at arm's length.

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

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

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

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

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

Periodical Costs

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

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

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

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

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

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

Consolidated Periodicals

If an exempt organization publishes more than one periodical to produce income, it may treat all of them (but not less than all) as one in determining UBTI from selling advertising. The gross income from all the periodicals, and the deductions directly connected with them is figured on a consolidated basis. Consolidated treatment, once adopted, must be followed consistently and is binding. This treatment can be changed only with the consent of the IRS.

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

1. The periodical generates gross advertising income to the organization equal to at least 25% of its readership costs, and
2. Publishing the periodical is an activity engaged in for profit.

Whether the publication of a periodical is an activity engaged in for profit can be determined only by all the facts and circumstances in each case. The facts and circumstances must show that the organization carries on the activity for economic profit, although there may not be a profit in a particular year. For example, if an organization begins publishing a new periodical whose total costs exceed total income in the start-up years because of lack of advertising sales, that doesn't mean that the organization didn't 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 isn't 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 UBTI. It may not consolidate the income and deductions from the newsletter with the income and deductions of its other periodicals, since the newsletter isn't published for the production of income.

Modifications

Net operating loss (NOL). An NOL arises when allowable deductions exceed gross unrelated trade or business income. Subject to modifications described in section 172, the NOL is allowed as a deduction against unrelated business taxable income for a tax year to which the NOL can be carried, as described below. The NOL for any tax year, the carryovers of NOLs, and the NOL deduction are determined without taking into account any amount of income or deduction that is specifically excluded in computing UBTI. For example, a loss from an unrelated trade or business isn't diminished because the organization received dividend income.

In line with this concept, an NOL can arise only in a tax year for which the organization is subject to tax on unrelated business income.

The Tax Cuts and Jobs Act (P.L. 115-97) and the CARES Act (P.L. 116-136) substantially modified the NOL provisions under section 172. Further, section 512(a)(6) (added by the Tax Cuts and Jobs Act) changed the way exempt organizations report and figure the tax on income from unrelated trade or business activity.

NOLs arising before 2018. Prior to the addition of section 512(b)(6), an exempt organization would compute its NOL (if any) for each tax year on an aggregate basis, regardless of the number of separate unrelated trades or business conducted by the organization. NOLs arising before 2018 (pre-2018 NOLs) can be carried forward for up to 20 years. Pre-2018 NOLs can be applied (subject to modifications) as a deduction to reduce unrelated business taxable income without regard to the unrelated trade or business activity that generated the income.

Even though an NOL can arise only in a tax year for which the organization is subject to tax on unrelated business income, the pre-2018 NOLs expire after 20 consecutive tax years. For example, if an organization was subject to the tax for 2014 and had an NOL for that year, the last tax year to which any part of that NOL may be carried over is 2034, regardless of whether the organization was subject to the unrelated business income tax in any of the intervening years.

NOLs arising in tax years after 2017. Section 512(a)(6) requires an organization with more than one unrelated trade or business to calculate UBTI in any tax year beginning after 2017, including for purposes of determining any NOL (post-2017 NOL) or applying any post-2017 NOL deduction, separately with respect to each such trade or business.

The Tax Cuts and Jobs Act (P.L.115-97, section 13302) amended section 172(b) to eliminate both the expiration of NOL carryforwards and the ability to carryback NOLs to earlier tax years. Certain farming and insurance company losses are exceptions and can be carried back as described in section 172(b). See Publication 225, Farmer's Tax Guide; Publication 536, Net Operating Losses; or Publication 542, Corporations; for additional information. However, the CARES Act added section 172(b)(1)(D), which provides for carryback of NOLs arising in 2018, 2019, and 2020 to each of the 5 years preceding the tax year in which the NOL arose. An organization that wishes to carry these NOLs forward must waive the carryback. See the Instructions for Form 990-T for more information.

In addition to largely eliminating NOL carrybacks (except for the CARES Act modification), the Tax Cuts and Jobs Act, as modified by the CARES Act, provides that the allowable NOL deduction for tax years beginning in 2021 cannot exceed 80% of taxable income.

An organization that had an NOL in a tax year beginning in 2018 or 2019 can file amended returns Form 990-T to carryback the NOL. See Pub. 536 for more information.

For more details on the NOL deduction, including property eligible for an extended carryback period, see section 172 and Pub. 536.

Charitable contributions deduction. An exempt organization is allowed to deduct its charitable contributions in computing its UBTI even if the contributions are not directly connected with any 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.

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.

Deduction limits. An exempt organization that is subject to the unrelated business income tax at corporate rates is allowed a deduction for charitable contributions up to 10% of its UBTI computed without regard to the deduction for contributions. See the Instructions for Form 990-T for more information.

An exempt trust that is subject to the unrelated business income tax at trust rates is generally 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 the trust's UBTI computed without regard to the deduction, rather than in relation to adjusted gross income.

Contributions in excess of the limits just described may be carried over to the next 5 tax years. A contribution carryover isn't allowed, however, to the extent that it increases an NOL carryover.

Specific deduction. In computing UBTI, a specific deduction of $1,000 is allowed. However, the specific deduction isn't allowed in computing an NOL or the NOL deduction.

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

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

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

This exception applies only to parishes, districts, or other local units that aren't 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 aren't separate legal entities. The local units can't file separate returns. However, each local unit that is separately incorporated must file its own return and can't 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.

Partnership Income or Loss

An organization may have unrelated business income or loss as a member of an entity classified as a partnership for federal tax purposes (see section 7701 and corresponding regulations), rather than through direct business dealings with the public. If so, it must treat its share of the partnership income or loss as if it had conducted the business activity in its own capacity as a corporation or trust. No distinction is made between limited and general partners or managing or non-managing members of a limited liability company. The organization is required to notify the partnership of its tax-exempt status. See Regulations section 1.512(a)-6 for information and transition rules under section 512(a)(6) for aggregating income from partnerships and debt-financed income from partnerships.

Thus, if an organization is a member of a partnership regularly engaged in a trade or business that is an unrelated trade or business with respect to the organization, the organization must include in its UBTI its share of the partnership's gross income from the unrelated trade or business (whether or not distributed), and the deductions attributable to it. The partnership income and deductions to be included in the organization's UBTI are figured the same way as any income and deductions from an unrelated trade or business conducted directly by the organization. The partnership is required to provide the organization this information on Schedule K-1.

Example. An exempt educational organization is a partner in a partnership that operates a factory. 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 UBTI but may exclude its share of any dividends the partnership received from the corporation.

Different tax years. If the exempt organization and the partnership of which it is a member have different tax years, the partnership items that enter into the computation of the organization's UBTI must be based on the income and deductions of the partnership for the partnership's tax year that ends within the organization's tax year.

S Corporation Income or Loss

An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, and losses in figuring UBTI, regardless of the actual source or nature of the income, deductions, and losses. For example, the organization's share of the S corporation's interest and dividend income will be taxable, even though interest and dividends are normally excluded from UBTI. The organization must also take into account its gain or loss on the sale or other disposition of the S corporation stock in figuring UBTI.

Special Rules for Foreign Organizations

The UBTI 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; and
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 865 and the related regulations.

Special Rules for Social Clubs, VEBAs, and SUBs

The following discussion applies to:

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

In general, these organizations are subject to the tax on income from unrelated trade or business activities and must apply the rules under section 512(a)(6). See Regulations section 1.512(a)-6 for more information. However, they must also must figure UBTI under special rules. Unlike other exempt organizations, they can't exclude their investment income (dividends, interest, rents, etc.). (See *Exclusions* under *Income*, earlier.) Therefore, they are generally subject to unrelated business income tax on this income.

The UBTI of these organizations includes all gross income, less deductions directly connected with the production of that income, except that gross income for this purpose doesn't include exempt function income. The deduction for dividends received by a corporation isn't allowed in computing UBTI because it isn't an expense incurred in the production of income.

Losses from nonexempt activities. Losses from nonexempt activities of these organizations can't be used to offset investment income.

Modifications. The UBTI is modified by any NOL or charitable contributions deduction and by the specific deduction (described earlier under *Deductions*).

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

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

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

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

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

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

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

Special Rules for Veterans' Organizations

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

Income From Controlled Organizations

The exclusions for interest, annuities, royalties, and rents, explained earlier in this chapter under *Income*, may not apply to a payment of these items received by a controlling organization from its controlled organization. The payment is included in the controlling organization's UBTI to the extent it reduced the net unrelated income (or increased the net unrelated loss) of the controlled organization. All deductions of the controlling organization directly connected with the amount included in its UBTI are allowed.

Excess qualifying specified payments. Excess qualifying specified payments received or accrued from a controlled entity are included in a controlling exempt organization's UBTI only to the extent of the amount that exceeds that would have been paid or accrued if the payments had been determined under section 482. Qualifying specified payments means any payments of interest, annuities, royalties, or rents received or accrued from the controlled organization pursuant to a binding written contract in effect on August 17, 2006, or to a contract which is a renewal, under substantially similar terms of a binding written contract in effect on August 17, 2006, and the payments are received or accrued after December 31, 2014.

If a controlled participant isn't required to file a U.S. income tax return, the participant must ensure that the copy or copies of the Regulations section 1.482-7 Cost Sharing Arrangement Statement and any updates are attached to Schedule M of any Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, any Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, or any Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, filed for that participant.

Addition to tax for valuation misstatements. Under section 512(b)(13)(E)(ii), the tax imposed on a controlling organization will be increased by 20% of the excess qualifying specified payments that are determined with or without any amendments or supplements to a return of tax, whichever is larger. See section 512(b)(13)(E)(ii) for more information.

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

Net unrelated loss. This is:
- For an exempt organization, its NOL, or
- For a nonexempt organization, the part of its NOL that would be its NOL if it were exempt and had the same exempt purposes as the controlling organization.

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

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

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

Income From Property Financed With Qualified 501(c)(3) Bonds

If any part of a 501(c)(3) organization's property financed with qualified 501(c)(3) bonds is used in a trade or business of any person other than a section 501(c)(3) organization or a governmental unit, and such use isn't consistent with the requirements for qualified 501(c)(3) bonds under section 145, the section 501(c)(3) organization is considered to have received unrelated business income in the amount of the greater of the actual rental income or the fair rental value of the property for the period it is used. No deduction is allowed for interest on the private activity bond. See sections 150(b)(3) and (c) for more information.

Disposition of Property Received From Taxable Subsidiary and Used in Unrelated Business

A taxable 80%-owned subsidiary corporation of one or more tax-exempt entities is generally subject to tax on a distribution in liquidation of its assets to its exempt parent (or parents). The assets are treated as if sold at fair market value.

Tax-exempt entities include organizations described in sections 501(a), 529, and 115, charitable remainder trusts, U.S. and foreign governments, Indian tribal governments, international organizations, and similar non-taxable organizations.

A taxable corporation that transfers substantially all of its assets to a tax-exempt entity in a transaction that otherwise qualifies for nonrecognition treatment must recognize gain on the transaction as if it sold the assets at fair market value. However, such a transfer isn't taxable if it qualifies as a like-kind exchange under section 1031 or an involuntary conversion under section 1033. In such a case, the built-in appreciation is preserved in the replacement property received in the transaction.

A corporation that changes status from taxable to tax-exempt is treated generally as if it transferred all of its assets to a tax-exempt entity immediately before the change in status (thus subjecting it to the tax on a deemed sale for fair market value). This rule doesn't apply where the taxable corporation becomes exempt within 3 years of formation, or had previously been exempt and within several years (generally a period of 3 years) regains exemption, unless the principal purpose of the transactions is to avoid the tax on the change in status.

In the transactions described above, the taxable event is deferred for property that the tax-exempt entity immediately uses in an unrelated business. If the parent later disposes of the property, then any gain (not in excess of the amount not recognized) is included in the parent's UBTI. If there is partial use of the assets in unrelated business, then there is partial recognition of gain or loss. Property is treated as disposed if the tax-exempt entity no longer uses it in an unrelated business.

Losses on the transfer of assets to a tax-exempt entity are disallowed if part of a plan with a principal purpose of recognizing losses.

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Income From Debt-Financed Property

Investment income that would otherwise be excluded from an exempt organization's UBTI (see *Exclusions* under *Income*, earlier) must be included to the extent it is derived from debt-financed property. The amount of income included is proportionate to the debt on the property.

Debt-Financed Property

In general, the term "debt-financed property" means any property held to produce income (including gain from its disposition) for which there is an acquisition indebtedness at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year). However, the tax on unrelated debt-financed income under section 514 does not apply to property used for an exempt purpose. See *Exceptions to Debt-Financed Property*, later. Sources of unrelated debt-financed income include rental real estate, tangible personal property, and corporate stock.

Acquisition Indebtedness

For any debt-financed property, acquisition indebtedness is the unpaid amount of debt incurred by an organization:

1. When acquiring or improving the property,
2. Before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement, and
3. After acquiring or improving the property if:
   a. The debt would not have been incurred except for the acquisition or improvement, and
   b. Incurring the debt was reasonably foreseeable when the property was acquired or improved.

The facts and circumstances of each situation determine whether incurring a debt was reasonably foreseeable. That an organization may not have foreseen the need to incur a debt before acquiring or improving the property doesn't necessarily mean that incurring the debt later wasn't reasonably foreseeable.

Example 1. Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building that Y rents to an insurance company for nonexempt purposes. The debt is acquisition indebtedness since the debt, though incurred after the improvement of the office building, would not have been incurred without the improvement, and the debt was reasonably foreseeable when, to make the improvement, Y reduced its working capital below the amount necessary to continue current operations.

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

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

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

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

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

Change in use of property. If an organization converts property that isn't debt-financed property to a use that results in its treatment as debt-financed property, the outstanding principal debt on the property is thereafter treated as acquisition indebtedness.

Example. Four years ago a university borrowed funds to acquire an apartment building as housing for married students. Last year, the university rented the apartment building to the public for nonexempt purposes. The outstanding principal debt becomes acquisition indebtedness as of the time the building was first rented to the public.

Continued debt. If an organization sells property and, without paying off debt that would be acquisition indebtedness if the property were debt-financed property, buys property that is otherwise debt-financed property, the unpaid debt is acquisition indebtedness for the new property. This is true even if the original property wasn't debt-financed property.

Example. To house its administration offices, an exempt organization bought a building using $600,000 of its own funds and $400,000 of borrowed funds secured by a pledge of its securities. The office building wasn't debt-financed property. The organization later sold the building for $1 million without repaying the $400,000 loan. It used the sale proceeds to buy an apartment building it rents to the general public. The unpaid debt of $400,000 is acquisition indebtedness with respect to the apartment building.

Property acquired subject to mortgage or lien. If property (other than certain gifts, bequests, and devises) is acquired subject to a mortgage, the outstanding principal debt secured by that mortgage is treated as acquisition indebtedness even if the organization didn't assume or agree to pay the debt.

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.

Liens similar to a mortgage. In determining acquisition indebtedness, a lien similar to a mortgage is treated as a mortgage. A lien is similar to a mortgage if title to property is encumbered by the lien for a creditor's benefit. However, when state law provides that a lien for taxes or assessments attaches to property before the taxes or assessments become due and payable, the lien isn't treated as a mortgage until after the taxes or assessments have become due and payable and the organization has had an opportunity to eliminate the lien by paying the amount it secured in accordance with state law. Liens similar to mortgages include (but aren't 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 in this paragraph).

Exception for property acquired by gift, bequest, or devise. If property subject to a mortgage is acquired by gift, bequest, or devise, the outstanding principal debt secured by the mortgage isn't treated as acquisition indebtedness during the 10-year period following the date the organization receives the property. However, this applies to a gift of property only if:

1. The mortgage was placed on the property more than 5 years before the date the organization received it, and
2. The donor held the property for more than 5 years before the date the organization received it.

This exception doesn't apply if an organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent (other than a payment under an annuity obligation excluded from the

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definition of acquisition indebtedness, discussed under *Debt That Isn't Acquisition Indebtedness*, later).

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

Modifying existing debt. Extending, renewing, or refinancing an existing debt is considered a continuation of that debt to the extent its outstanding principal doesn't increase. When the principal of the modified debt is more than the outstanding principal of the old debt, the excess is treated as a separate debt.

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

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

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

Debt increase. If the outstanding principal of a modified debt is more than that of the unmodified debt, and only part of the refinanced debt is acquisition indebtedness, the payments on the refinanced debt must be allocated between the old debt and the excess.

Example. An organization has an outstanding principal debt of $500,000 that is treated as acquisition indebtedness. The organization borrows another $100,000, which isn't acquisition indebtedness, from the same lender, resulting in a $600,000 note for the total obligation. A payment of $60,000 on the total obligation would reduce the acquisition indebtedness by $50,000 ($60,000 x $500,000/$600,000) and the excess debt by $10,000.

Debt That Isn't Acquisition Indebtedness

Certain debt and obligations aren't acquisition indebtedness. These include the following.

- Debts incurred in performing an exempt purpose.
- Annuity obligations.
- Securities loans.
- Real property debts of qualified organizations.
- Certain Federal financing.

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

Annuity obligation. The organization's obligation to pay an annuity isn't acquisition indebtedness if the annuity meets all the following requirements.

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

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

Securities loans. Acquisition indebtedness doesn't include an obligation of the exempt organization to return collateral security provided by the borrower of the exempt organization's securities under a securities loan agreement (discussed under *Exclusions*, earlier in this chapter). This transaction isn't treated as the borrowing by the exempt organization of the collateral furnished by the borrower (usually a broker) of the securities.

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

Short sales. Acquisition indebtedness doesn't include the "borrowing" of stock from a broker to sell the stock short. Although a short sale creates an obligation, it doesn't create debt.

Real property debts of qualified organizations. In general, acquisition indebtedness doesn't include debt incurred by a qualified organization in acquiring or improving any real property. A qualified organization is:

1. A qualified retirement plan under section 401(a),
2. An educational organization described in section 170(b)(1)(A)(ii) and certain of its affiliated support organizations,
3. A title-holding company described in section 501(c)(25), or
4. A retirement income account described in section 403(b)(9) in acquiring or improving real property in tax years beginning on or after August 17, 2006.

This exception from acquisition indebtedness doesn't apply in the following six situations.

1. The acquisition price isn't 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. However, see *Note 1* at the end of this list.
2. Any debt or other amount payable for the debt, or the time for making any payment, depends, in whole or in part, upon any revenue, income, or profits derived from the real property. However, see *Note 1* at the end of this list.
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). However, see *Note 2* at the end of this list.
4. The real property is acquired by a qualified retirement plan from, or after its acquisition is leased by a qualified retirement plan to, a related person. However, see *Note 2* at the end of this list. For this purpose, a related person is:
   a. An employer who has employees covered by the plan,
   b. An owner with at least a 50% interest in an employer described in (a),
   c. A member of the family of any individual described in (a) or (b),
   d. A corporation, partnership, trust, or estate in which a person described in (a), (b), or (c) has at least a 50% interest, or
   e. An officer, director, 10% or more shareholder, or highly compensated employee of a person described in (a), (b), or (d).

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5. The seller, a person related to the seller (under section 267(b) or section 707(b)), or a person related to a qualified retirement plan (as described in (4)) provides financing for the transaction on other than commercially reasonable terms.

6. The real property is held by a partnership in which an exempt organization is a partner (along with taxable entities), and the principal purpose of any allocation to an exempt organization is to avoid tax. This generally applies to property placed in service after 1986. For more information, see section 514(c)(9)(B)(vi) and section 514(c)(9)(E).

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

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

Certain federal financing. Acquisition indebtedness doesn't include an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low or moderate income people.

In addition, acquisition indebtedness doesn't include indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 after October 22, 2004, if such indebtedness is evidenced by a debenture issued by such company and held or guaranteed by the Small Business Administration. However, this provision doesn't apply to any small business investment company during any period that any organization which is exempt from tax (other than a governmental unit) owns more than 25% of the capital or profits interest in such company, or organizations which are exempt from tax (including governmental agencies other than any agency or instrumentality of the United States) own, in the aggregate, 50% or more of the capital or profits interest in such company.

Exceptions to Debt-Financed Property

Certain property is excepted from treatment as debt-financed property.

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

1. A comparison of the time the property is used for exempt purposes with the total time the property is used,

2. A comparison of the part of the property that is used for exempt purposes with the part used for all purposes, or

3. Both of these comparisons.

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

Property used in an unrelated trade or business. To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, the property isn't treated as debt-financed property. However, any gain on the disposition of the property 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 don't apply to rents from personal property, certain passive income from controlled organizations, and other amounts that are required by other rules to be included in computing UBTI.

Property used in research activities. Property isn't treated as debt-financed property when it produces gross income derived from research activities otherwise excluded from the unrelated trade or business tax. See *Income from research* under *Exclusions*, earlier in this chapter.

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

1. It has a volunteer workforce,

2. It is conducted for the convenience of its members, or

3. It consists of selling donated merchandise.

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

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

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

1. One organization is an exempt holding company and the other receives profits derived by the exempt holding company,

2. One organization controls the other as discussed under *Income From Controlled Organizations* earlier in this chapter,

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 isn't 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.

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 aren't unrelated debt-financed income.

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

Neighborhood land rule. If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property that the organization uses for exempt purposes. This rule applies only if the intent to demolish any existing structures and use the land for exempt purposes within 10 years isn't abandoned.

Property is considered in the neighborhood of property that an organization owns and uses for its exempt purposes if it is contiguous with the exempt purpose property or would be contiguous except for an intervening road, street, railroad, stream, or similar property. If it isn't contiguous with the exempt purpose property, it still may be in the same neighborhood if it is within 1 mile of the exempt purpose property and if the facts and circumstances make it unreasonable to acquire the contiguous property.

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

Example. A university tries to buy land contiguous to its present campus, but can't do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university buys this land. Under these circumstances, the contiguity requirement is unreasonable and not applicable. The land bought would be considered neighborhood land.

Exceptions. For all organizations other than churches and conventions or associations of churches, discussed later under *Churches*, the neighborhood land rule doesn't apply to property after the 10 years following its

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acquisition. Further, the rule applies after the first 5 years only if the organization satisfies the IRS that use of the land for exempt purposes is reasonably certain before the 10-year period expires. The organization need not show binding contracts to satisfy this requirement; but it must have a definite plan detailing a specific improvement and a completion date, and it must show some affirmative action toward the fulfillment of the plan. This information should be forwarded to the IRS for a ruling at least 90 days before the end of the 5th year after acquisition of the land. Send information to:

Internal Revenue Service
Attn: CC:PA:LPD:DRU
P.O. Box 120, Ben Franklin Station
Washington, DC 20044

If a private delivery service is used, the address is:

Internal Revenue Service
Attn: CC:PA:LPD:DRU, Room 5336
1111 Constitution Ave. NW
Washington, DC 20224

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

CAUTION *For any updates to these addresses go to IRS.gov/Pub598.*

Actual use. If the neighborhood land rule doesn't apply because the acquired land isn't 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 isn't 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 isn't debt financed so long as the organization doesn't abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. 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 don't apply to structures erected on land after its acquisition. They don't apply to property subject to a business lease (as defined in section 1.514(f)-1 of the regulations) whether an organization acquired the property subject to the lease, or whether it executed the lease after acquisition. A business lease is any lease, with certain exceptions, of real property for a term of more than 5 years by an exempt organization if at the close of the lessor's tax year there is a business lease (acquisition) indebtedness on that property.

Refund of taxes. When the neighborhood land rule doesn't initially apply, but the land is eventually used for exempt purposes, a refund or credit of any overpaid taxes will be allowed for a prior tax year as a result of the satisfaction of the actual use rule. A claim must be filed within 1 year after the close of the tax year in which the actual use rule is satisfied. Interest rates on any overpayment are governed by the regulations.

Example. In January 2009, Y, a calendar year exempt organization, acquired real property contiguous to other property that Y uses in furtherance of its exempt purpose. Assume that without the neighborhood land rule, the property would be debt-financed property. Y didn't satisfy the IRS by January 2014 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 2014 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 2018, 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 2015 through 2017.

Further, Y also can file a claim for refund for 2014, 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 2019.

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

1. The period during which the organization must demonstrate the intent to use acquired property for exempt purposes is increased from 10 to 15 years, and
2. Acquired property doesn't have to be in the neighborhood of other property used by the organization for exempt purposes.

Thus, if a church or association or convention of churches acquires real property for the primary purpose of using the land in the exercise or performance of its exempt purpose, within 15 years after the time of acquisition, the property isn't treated as debt-financed property as long as the organization doesn't 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 doesn't apply to any property after the 15-year period expires. Further, this rule will apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the IRS that use of the acquired land in furtherance of the organization's exempt purpose is reasonably certain before the 15-year period expires.

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

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

Computation of Debt-Financed Income

For each debt-financed property, the unrelated debt-financed income is a percentage (not over 100%) of the total gross income derived during a tax year from the property. This percentage is the same percentage as the average acquisition indebtedness with respect to the property for the tax year of the property's average adjusted basis for the year (the debt/basis percentage). Thus, the formula for deriving unrelated debt-financed income is:

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

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 or loss from sale or other disposition of property. If an organization sells or otherwise disposes of debt-financed property, it must include, in computing UBTI, 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.

Debt-financed property exchanged for subsidiary's stock. A transfer of debt-financed property by a tax-exempt organization to its wholly owned taxable subsidiary, in exchange for additional stock in the subsidiary, isn't 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

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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 didn't result in a gain subject to the tax on unrelated business income.

Gain or loss on disposition of certain brownfield property. Gain or loss from the qualifying sale, exchange, or other disposition of a qualifying brownfield property (as defined in section 512(b)(19)(C)), which was acquired by the organization after December 31, 2004, is excluded from UBTI and is excepted from the debt-financed rules for such property. See sections 512(b)(19) and 514(b)(1)(E).

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Average acquisition indebtedness. This is 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.

Indeterminate price. If an organization acquires or improves property for an indeterminate price (that is, neither the price nor the debt is certain), the unadjusted basis and the initial acquisition indebtedness are determined as follows, unless the organization obtains the IRS's consent to use another method:

- The unadjusted basis is the fair market value of the property or improvement on the date of acquisition or completion of the improvement.
- The initial acquisition indebtedness is the fair market value of the property or improvement on the date of acquisition or completion of the improvement, less any down payment or other initial payment applied to the principal debt.

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 isn't 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 doesn't affect the amount of the depreciation adjustment to use in determining average adjusted basis.

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

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

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

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

	Basis
As of July 7	$ 510,000
As of December 31	490,000
Total	$1,000,000
Average adjusted basis: $1,000,000 ÷ 2	$ 500,000
Debt/basis percentage	
$250,000 ÷ $500,000	= 50%

Deductions for Debt-Financed Property

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

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

1. The allowable deductions are subject to the modifications for computation of the UBTI (discussed earlier in this chapter); and
2. The depreciation deduction, if allowable, is computed only by use of the straight-line method.

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

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

Capital losses. If a sale or exchange of debt-financed property results in a capital loss, the loss taken into account in the tax year in which the loss arises is computed as provided earlier. See *Gain or loss from sale or other disposition of property* under *Computation of Debt-Financed Income*, earlier.

If any part of the allowable capital loss isn't taken into account in the current tax year, it may be carried back or carried over to another tax year as provided in section 1212 , 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 (subject to limitations under section 1212) without further application of the debt/basis percentage.

NOL. 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 an NOL for the tax year. This amount may be carried over to other tax years in the same manner as any other NOL of an organization with UBTI. (For a discussion of the NOL deduction, see *Modifications* under *Deductions*, earlier in this chapter.) 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 UBTI 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 UBTI, $10,000 (50% of $20,000) of income and $12,500 (50% of $25,000) of the deductions directly connected with that income.

Thus, Y sustained an NOL of $2,500 ($10,000 of income less $12,500 of deductions), which may be carried back or carried over to other tax years (as provided in section 172) without further application of the debt/basis percentage.

Allocation Rules

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

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

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

Since the two lower stories were used for exempt purposes, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with this income are taken into account in computing UBTI. The part taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with the rental income by the debt/basis percentage.

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

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

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

5.

How To Get Tax Help

Photographs of Missing Children. The IRS is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Phone Help. If you have questions and/or need help completing this form, please call 877-829-5500. This toll-free telephone service is available Monday through Friday.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at IRS.gov to:

- Download forms and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- Use the online Internal Revenue Code (IRC), Regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Sign up to receive local and national tax news by email. To subscribe, visit *IRS.gov/Charities*.

Ordering Forms and Publications. Visit *IRS.gov/FormsPubs* to download forms and publications. Otherwise, you can go to *IRS.gov/OrderForms* to order current and prior-year forms and instructions. Your order should arrive within 10 business days.

DRAFT AS OF March 25, 2021

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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