17
Taxation of Investment and Business Activities of Tax-Exempt Corporations

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This chapter discusses tax considerations concerning a nonprofit organization’s income from investments and business activities. The chapter covers the taxation of investment income of private foundations (see §§17.3–17.10) and the taxation of recapture income (see §17.11). It includes an extensive discussion of the taxation of unrelated business income and how that concept is defined. See §§17.12–17.67. The chapter also briefly addresses issues arising when operating a business through another entity (see §§17.68–17.74), as well as the taxation of investments in tax shelters (see §§17.75–17.78).

§17.2 II. SOURCES OF FUNDS

Tax-exempt corporations obtain funds from several sources, such as charitable contributions (see chap 15); dues, membership fees, and similar assessments (see §10.121); auctions, dinner dances, athletic events, and other fundraising efforts (see chap 15); borrowing (see §§17.45–17.58 and §§18.2–18.4); business activities; and investments. Subject to the limitations on the ownership of excess business holdings by private foundations (see §4.41) and possible loss of certain advantages, including loss of tax-exempt status (see §17.67), a tax-exempt corporation may carry on business and investment activities directly or through other corporations, partnerships, limited liability companies, and other entities.

A tax-exempt organization that is a private foundation pays a federal excise tax on its net investment income. See §§4.40, 17.3–17.10. Income characterized as recapture of certain prior tax deductions will be taxed to an exempt organization. See §17.11. In some circumstances, income derived from sources other than charitable contributions and borrowing will be taxed as unrelated business taxable income. In a few situations, a tax-exempt corporation’s ownership interest in another entity can affect the income tax liabilities of that entity or other entities. If a tax-exempt entity is a party to a prohibited tax shelter transaction, the entity and its managers may be subject to federal excise taxes. See §§17.75–17.78.
III. TAXATION OF INVESTMENT INCOME OF PRIVATE FOUNDATIONS

§17.3 A. Taxation and Exemption From Taxation

Except for exempt operating foundations (see §4.50), private foundations pay an annual federal excise tax on their net investment income. IRC §4940(a). See §4.40.

There is no similar tax imposed under California law. For a more detailed discussion of the excise tax imposed on the investment income of private foundations, see Hill & Mancino, Taxation of Exempt Organizations ¶¶12.01–12.02(6) (2002 B Supp 2013–2).

§17.4 B. Normal Tax Rates

The annual tax rate imposed on private foundations that are exempt from federal income tax under IRC §501(c) is normally 2 percent of net investment income. IRC §4940(a). The tax imposed on private foundations that are not exempt is equal to the excess, if any, of 2 percent of net investment income plus the tax that would have been paid on unrelated business taxable income (see §17.12) had the private foundation been exempt, over the normal federal income tax that the organization is obligated to pay.

§17.5 C. Reduction in Tax

A tax-exempt private foundation may reduce its tax on net investment income from 2 percent to 1 percent if it increases its qualified distributions (see §4.40). IRC §4940(e). This decreased rate will apply for a particular taxable year if the private foundation was not liable for excise tax under IRC §4942 for any of the 5 preceding taxable years, and the sum of the qualified distributions made during that year equals or exceeds the sum of (IRC §4940(e)(2))

- One percent of the net investment income for such year, and
- The average percentage paid on the value of its investment assets for the previous 5 years multiplied by the value of its investment assets for such taxable year.

PRACTICE TIP: The disadvantage of qualifying for this reduction on a continuous basis is that it requires a private foundation to continue to ratchet up its qualifying distributions from year to year. Therefore, foundations often employ it only in those years when they have unusually large amounts of net investment income.

§17.6 D. Net Investment Income

Net investment income is the amount by which the sum of gross investment income and capital gain net income exceeds allowable deductions. IRC §4940(c)(1). Net investment income does not include interest that is exempt from tax under IRC §103.

§17.7 1. Gross Investment Income

Gross investment income means the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in IRC §512(a)(5)), royalties, and similar sources but does not include any unrelated business taxable income. IRC §4940(c)(2).
§17.8  2. Capital Gain Net Income

Capital gains or losses from the sale of property are taken into consideration to the same extent that they are taken into account for purposes of computing the tax on unrelated business taxable income (see §17.29). IRC §4940(c)(4)(A). Property held on December 31, 1969, has a tax basis equal to its value on that date. IRC §4940(c)(4)(B). Capital losses are allowed only to the extent of capital gains, and there are no loss carryovers or carrybacks. IRC §4940(c)(4)(C). Gain or loss from the sale of property that has been used for at least 1 year for an exempt purpose or function will not be taken into account if exchanged for similar property; rules similar to those in IRC §1031 apply. IRC §4940(c)(4)(D).

§17.9  3. Allowable Deductions

The deductions that may be taken in determining net investment income are those for ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of income. IRC §4940(c)(3)(A). For this purpose, depreciation must be claimed on the straight-line basis, and no percentage depletion may be claimed. IRC §4940(c)(3)(B).

§17.10  E. Reporting of Taxes

The 2-percent (or 1-percent) excise tax imposed by IRC §4940 is reported on the IRS Form 990-PF. The tax must be paid on an estimated basis in quarterly installments. IRC §6655(g).

§17.11  IV. RECAPTURE INCOME

Any recapture income realized as a result of the sale or exchange of property pursuant to the following IRC provisions is fully taxable to an exempt organization:

- IRC §1245: Depreciation recapture on the disposition of personal property.
- IRC §1250: Depreciation recapture on the disposition of real property.
- IRC §1252: Recapture of certain expenditures on the disposition of farm lands.
- IRC §1254: Recapture of certain expenditures on the disposition of interests in oil, gas, geothermal, or other mineral properties.
- IRC §1255: Recapture of certain government cost-sharing program payments for conservation purposes on the disposition of property.
- IRC §1257: Gain realized on the disposition of certain converted wetlands or highly erodible croplands.

These IRC provisions override all other statutory exclusions, including those pertaining to tax exemption (IRC §501(a)) and unrelated business taxable income (IRC §§511–514). For recapture of depreciation under IRC §§1245 and 1250, only depreciation allowed or allowable in computing an exempt organization’s unrelated business income or in computing taxable income of the organization (or a predecessor organization, in the case of §1245 property) when it was not exempt is taken into account. Treas Reg §§1.1245–2(a)(8), 1.1250–2(d)(6). While this same rule logically should apply to recapture
income under IRC §§1252, 1254, and 1255, the regulations under those sections do not contain such a rule.

V. UNRELATED BUSINESS INCOME TAX (UBIT)

§17.12 A. Imposition of Tax

Income subject to UBIT. A nonprofit organization otherwise exempt from federal income tax is taxed on net income realized from a regularly conducted trade or business that is unrelated to the purpose or functions that qualify the organization for tax exemption. Taxes may also be imposed on income from the following sources:

- Property subject to a mortgage or other encumbrance and assets purchased with borrowed funds (see §§17.45–17.58);
- Payments received from controlled entities (IRC §512(b)(13); see §§17.68–17.74);
- Deemed distributions from insurance income of a controlled foreign corporation (see §17.40); and
- Net income earned on certain private-use property funded with proceeds from tax-exempt bond financing (see §17.34).

If an organization’s unrelated trade or business is or will be relatively substantial, the organization may lose, or fail to obtain, tax-exempt status. See §17.67. Unrelated business income could also result in a partial or complete loss of the welfare exemption from property tax (see chap 11), disqualification of tax-exempt bond financing (see chap 18), and limitation on reduced postal rates (see §13.52).

California law. California tax law generally conforms to federal tax law on taxation of unrelated business income of exempt organizations. Rev & T C §§23731–23741. Any differences between federal and state law are noted in this chapter.

For more detailed discussions of the taxation of unrelated business income, see Hopkins, The Law of Tax-Exempt Organizations (10th ed 2011); Frietag, Unrelated Business Income Tax, Tax Mgmt Portfolios 874–2d (2001). The publications Cobb, UBIT Traps in Alternative Revenue, 14 Exempt Org Tax Rev 229 (Aug. 1996) and Hasson, Controversies Old and New Mark Recent UBIT Developments, 10 J Tax’n Exempt Orgs 123 (Nov./Dec. 1998) discuss several activities that have been the subject of IRS scrutiny (e.g., licensing and royalty arrangements, insurance arrangements, advertising, catalog and bookstore sales, corporate sponsorship, travel tours).

Social clubs. Social clubs (described in IRC §501(c)(7)), voluntary employees’ beneficiary associations (described in IRC §501(c)(9)), supplemental unemployment plan trusts (described in IRC §501(c)(17)), and group legal service plans (described in IRC §501(c)(20)) are taxed under a special rule. These organizations are taxed on all income except the following (IRC §512(a)(3)):

- Membership income;
- Capital gains from the sale of real property that are used to further an exempt purpose, if those gains are reinvested in such kind of property; and
- Certain income paid or set aside for charitable purposes or, as to voluntary employees’ associations, supplemental employment plan trusts, and group legal service plans, for the payment of certain benefits.
This income is taxable to these types of corporations whether or not the activity generating the income is conducted regularly. *Ye Mystic Krewe of Gasparilla* (1983) 80 TC 755.

### §17.13 B. Organizations Subject to Tax

With two limited exceptions, the following organizations are subject to federal tax on unrelated business taxable income (IRC §§501(b), 511(a)(2)):

- Organizations exempt from federal income tax under IRC §501(a) (including organizations described in IRC §§401(a), 501(c)–(d));
- Public colleges and universities; and
- Corporations wholly owned by public colleges or universities.

The exceptions to this rule are corporations organized under an act of Congress that are exempt under that act from federal income tax (IRC §§501(c)(1), 511(a)(2)(A)) and certain federally licensed businesses of religious orders (IRC §512(b)(15)).

Corporations exempt under Chapter 4 of Part 11 of Division 2 the California Revenue and Taxation Code (Rev & T C §§23701–23778) are subject to California tax on their unrelated business taxable income. Rev & T C §23731(a). A charitable trust that is tax-exempt under Rev & T C §23701d is defined as a “corporation.” Rev & T C §23038(e).

### C. Definition of “Unrelated Trade or Business”

### §17.14 1. Basic Test

An “unrelated trade or business” is an enterprise that is regularly carried on (see §17.20) by an exempt organization and that is not substantially related (other than through the production of funds) to the organization’s exercise or performance of its exempt purposes (see §17.23). IRC §513(a). The term generally does not include businesses (IRC §513(a))

- In which substantially all the work is performed by volunteers;
- That operate primarily for the convenience of their members, students, patients, officers, or employees; or
- That sell merchandise, substantially all of which has been received as gifts or contributions.

Fundraising activities that are regularly carried on, including but not limited to awards of premiums in consideration for charitable contributions, lotteries, and golf tournaments, will be unrelated businesses unless they are covered by one of the exclusions discussed in §§17.25–17.43.

### 2. Elements of Basic Test

### §17.15 a. Trade or Business

Although there is no authoritative definition of the term “trade or business” (see 1 Bittker & Lokken, Federal Taxation of Income, Estates and Gifts §20.1.2 (3d ed rev 2005)), the term has the same meaning
in the unrelated trade or business context as elsewhere in the Internal Revenue Code (Cooper Tire & Rubber Co. Employees’ Retirement Fund (1961) 36 TC 96, aff’d (6th Cir 1962) 306 F2d 20). Generally, a trade or business is an activity that involves selling goods or services to produce income. IRC §513(c); Treas Reg §1.513–1(b). For example, providing insurance to members constitutes the conduct of a trade or business because the activity involves sales and the performance of services and possesses the general characteristics of a trade or business. U.S. v American Bar Endowment (1986) 477 US 105, 106 S Ct 2426.

§17.16  (1) Comparison With Nonexempt Enterprises

An activity may be a trade or business even if it does not compete with taxable enterprises. Clarence LaBelle Post No. 217 v U.S. (8th Cir 1978) 580 F2d 270. But see Hope Sch. v U.S. (7th Cir 1980) 612 F2d 298 (lack of competition primary but not sole factor in deciding whether there was unrelated trade or business). The continuing validity of the Hope decision is questioned in Veterans of Foreign Wars (1987) 89 TC 7.

For a review of cases discussing the importance of competitive and commercial efforts by an exempt organization in determining whether an unrelated trade or business exists, see Carolinas Farm & Power Equip. Dealers Ass’n v U.S. (4th Cir 1983) 699 F2d 167. In any event, comparison with nonexempt enterprises may otherwise be relevant, e.g., in determining whether a trade or business is regularly carried on. See §17.20.

§17.17  (2) Profit Intent

To be a “trade or business,” an activity must be carried on with the intention of making a profit. Texas Farm Bureau v U.S. (5th Cir 1995) 53 F3d 120, 125 (determining whether profit motive exists is “key inquiry”); Veterans of Foreign Wars (1987) 89 TC 7. Losses do not prevent an activity carried on for profit from being a “trade or business.” IRC §513(c).

§17.18  (3) Operation as Part of Larger Enterprise

A trade or business does not lose its separate identity merely because it is a part of a larger endeavor that is conducted to further an exempt purpose. IRC §513(c). For example, although the publication of a monthly medical journal may be an exempt function, sales of advertisements in that journal can be an unrelated trade or business. U.S. v American College of Physicians (1986) 475 US 834, 106 S Ct 1591 (see §17.23). Similarly, although an exempt hospital’s operation of a pharmacy is an exempt function, the pharmacy’s regular sales to persons who are not hospital patients can be an unrelated trade or business.

§17.19  (4) Providing “Commercial Type” Insurance

A tax-exempt organization that writes “commercial type” insurance that is not a substantial part of its exempt purpose activities is treated as carrying on an unrelated trade or business and is taxed as an insurance company under IRC §§801–848 rather than under IRC §511. IRC §501(m)(2). See Paratransit Ins. Corp. (1994) 102 TC 745; Nonprofits’ Ins. Alliance v U.S. (1994) 32 Fed Cl 277. (However, Nonprofits’ Insurance Alliance is now exempt under IRC §501(n) and its insurance activities are not taxed as an unrelated trade or business.)
§17.20 b. Regularly Carried On

In determining whether a trade or business is regularly carried on, its frequency and continuity are compared with similar activities of a nonexempt organization. Treas Reg §1.513–1(c)(1). Determining whether “intermittent” activities are regular may present difficult factual questions, and the cases and rulings dealing with the issue are not always consistent in their conclusions.

An activity is not “regular” if it is carried on for only 1 or 2 weeks a year by an exempt enterprise as compared with a similar activity carried on daily throughout the year by nonexempt enterprises. However, once a week throughout the year is considered “regular.” If the normal span of an activity is seasonal, such as horse racing, then “regularity” is determined with reference to that span. Treas Reg §1.513–1(c)(2)(i).

Infrequent conduct, such as an annual dance or a fundraising event, is not regular. Treas Reg §1.513–1(c)(2)(iii). Casual sales in conjunction with an exempt activity, such as occasional sales to persons other than patients by a hospital pharmacy or to persons other than students by a college bookstore, are not regular. Conversely, when nonqualifying sales are not merely casual, but systematically and consistently promoted and carried on, they are regularly carried on. Treas Reg §1.513–1(c)(2)(ii).

§17.21 (1) Advertising Sales

Income from selling advertising space in programs for an annual basketball championship tournament has been held not to be a regularly carried on business. National Collegiate Athletic Ass’n v Commissioner (10th Cir 1990) 914 F2d 1417. The relevant period in determining whether the activity was intermittent was held to be the approximately 3-week-long tournament when the games were played and the advertising actually occurred. The court thus ignored the considerable time and effort spent in soliciting advertisements and preparing the programs for publication before the tournament. See also Suffolk County Patrolmen’s Benevolent Ass’n (1981) 77 TC 1314, 1321, acq 1984–2 Cum Bull 2 (despite up to 16 weeks of professional solicitation of advertising for program for annual event, activity was deemed intermittent, not “regularly carried on”).

Income from selling displays and listings in an annual yearbook was held to be unrelated business taxable income in State Police Ass’n v Commissioner (1st Cir 1997) 125 F3d 1, cert denied (1998) 522 US 1108. The court distinguished Suffolk County Patrolmen’s Benevolent Association and National Collegiate Athletic Association on the ground that the advertising in those cases was associated with particular events, suggesting that independent publications are to be treated differently than events.

The IRS has attempted to limit the reach of the decision in Suffolk County Patrolmen’s Benevolent Association, and has expressed its disagreement with the decision of the court of appeals in National Collegiate Athletic Association. In IRS Letter Ruling 9712001, the IRS ruled that a concert series sponsored by an association of local firefighters’ unions exempt under IRC §501(c)(5) conducted twice each year in several areas of a state was an unrelated trade or business. Tickets to the events were sold via telemarketing efforts employed in a solicitation campaign conducted by an independent commercial firm throughout most of the year, and there was a 6-month preparatory period for each series of events. See also IRS Letter Ruling 200128059, in which the IRS concluded that income from selling advertising in connection with an annual golf tournament was an unrelated trade or business.
§17.22  (2) Single Occurrences

A termination agreement by which an exempt organization receives a single payment in consideration for its nonsponsorship and noncompetition commitment is not a regularly carried on business. *Ohio Farm Bureau Fed’n* (1996) 106 TC 222, 233.

The lease by a tax-exempt aeronautical museum of an airplane (which had been donated to the museum) to an aircraft manufacturer to test engines was held not to be a regularly conducted activity. *Museum of Flight Found. v U.S.* (WD Wash 1999) 63 F Supp 2d 1257. The court distinguished *Cooper Tire & Rubber Co. Employees’ Retirement Fund* (1961) 36 TC 96, aff’d (6th Cir 1962) 306 F2d 20, which found that income received by an exempt organization from the lease of tire manufacturing machines that it purchased was taxable even though the exempt organization engaged in one single leasing transaction.

§17.23  c. Relationship to Exempt Purpose

**Determining if business is “substantially related.”** A trade or business must contribute importantly to an organization’s exempt purposes other than through the production of funds to be “substantially related” to those purposes. Treas Reg §1.513–1(d)(2). The fact that profits of the trade or business are used by a nonprofit corporation for exempt purposes or are essential to its financial well-being does not convert an unrelated activity into a related activity. Determining whether an activity is substantially related to an organization’s exempt purposes requires careful examination of those purposes. The degree to which an activity furthers an exempt purpose may vary according to the circumstances, and fine distinctions may be made. For example, commercial operation of a television station by a state university was found unrelated even though there was substantial student and faculty involvement. *Iowa State Univ. of Science & Technol. v U.S.* (Ct Cl 1974) 500 F2d 508. On the other hand, the sale of radio and television broadcasting rights for a football game by a regional athletic conference was related because the event itself was related to the educational purposes of the member colleges. Rev Rul 80–296, 1980–2 Cum Bull 195. In *Ocean Pines Ass’n, Inc.* (2010) 135 TC 276, 283, aff’d (4th Cir 2012) 672 F3d 284, the operation of parking lots and a beach club for members of a homeowners association exempt under IRC §501(c)(4) were held unrelated because these facilities were not open to the general public and thus did not promote social welfare as required by §501(c)(4). The sale of life and disability insurance to cover mortgage payments on loans made by a credit union was held to be substantially related to an exempt purpose of the credit union. *Bellco Credit Union v U.S.* (DC Colo 2010) 735 F Supp 2d 1286.

**Are sales of product related?** Disposing of the product of an exempt function may be related if no business efforts are made beyond those appropriate or necessary to that function. However, conducting an activity commercially beyond that necessary to support an exempt purpose is treated as an unrelated business to the extent of the excess, *e.g.*, the sale of milk and cream from a scientific dairy herd is related, whereas the sale of ice cream made from the milk and cream may not be. Treas Reg §1.513–1(d)(4)(ii).

**Is dual use of facility related?** Dual use of assets or facilities may result in an unrelated activity. For example, a museum’s use of its auditorium during evening hours as an ordinary motion picture theater showing current films for public entertainment would be unrelated. Treas Reg §1.513–1(d)(4)(iii).

**Sales by hospital pharmacy.** Income from sales by a hospital pharmacy to private patients of staff doctors is related business income if the sales serve the hospital’s exempt purposes by attracting doctors to a rural area hospital, but sales to the general public are an unrelated business. *Hi-Plains Hosp. v U.S.* (5th Cir 1982) 670 F2d 528. Pharmacy sales to private patients of staff doctors who operated an
independent clinic adjacent to the hospital were also found unrelated. *Carle Found. v U.S.* (7th Cir 1979) 611 F2d 1192.

**Sales of advertising in medical journal.** Sales of advertising in a scholarly medical journal are an unrelated trade or business even though publication of the journal is *not* unrelated to the educational purposes of the organization. *U.S. v American College of Physicians* (1986) 475 US 834, 106 S Ct 1591. In *American College*, the court rejected the IRS’s argument that advertising per se constitutes an unrelated trade or business and held that the determination of whether the sale of advertising is related to an organization’s exempt purposes should be made on the basis of how the organization conducts the activity rather than on the basis of the effect of the activity on subscribers. In this case, the appropriate inquiry was whether the publisher of the journal performed the advertising services in a manner that showed an intention to use the advertisements for the purpose of contributing to the educational value of the journal. The court concluded that the organization had not intended to do so for the following reasons (475 US at 849):

- The organization did not use its advertising to provide readers with a comprehensive or systematic presentation;
- Advertisements were sold to anyone willing to pay;
- Advertisements were often repeated and were for established drugs or devices; and
- Some advertisements concerned matters that had no conceivable relationship to the organization’s exempt purposes.

**IRS rulings on specific activities.** The IRS has taken positions on the following specific activities:

- **Travel tours** conducted by educational, cultural, and other organizations (Treas Reg §1.513–7 provides six examples of travel tour programs conducted by exempt organizations that may be treated by the IRS as substantially related or not substantially related to an organization’s exempt purposes; each program must be examined on the basis of its relevant facts and circumstances, including, but not limited to how a travel tour is developed, promoted, and operated);
- **Bookstore and catalog sales by museums** (see Rev Rul 73–104, 1973–1 Cum Bull 263 (related); Rev Rul 73–105, 1973–1 Cum Bull 264 (related); IRS Letter Ruling 9550003 (unrelated)); and
- **Rental of a museum’s facilities** for corporate and social events (see IRS Technical Advice Memorandum 9702003 (unrelated); *John W. Madden, Jr.*, TC Memo 1997–395 (related; rental of museum property for private celebrations not unrelated activity because museum’s primary intent in making its facilities available was to further its educational purposes not to raise revenue)).

**§17.24** 3. **Qualified Sponsorship Income**

Solicitation and receipt of a “qualified sponsorship payment,” e.g., a payment received in support of an athletic event conducted by an exempt organization for which the payor only receives recognition, is not an unrelated trade or business. IRC §513(i). This exclusion does not apply to payments made in connection with either qualified convention and trade show activities (see §17.35) or income from the sale of advertising or acknowledgments in a regularly scheduled periodical that is not related to and primarily distributed with respect to a particular event conducted by an exempt organization. IRC §513(i)(2)(B)(ii).
“Qualified sponsorship payment” and “substantial return benefit” defined. The term “qualified sponsorship payment” means “any payment by any person engaged in a trade or business with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit.” Treas Reg §1.513–4(c)(1). A “substantial return benefit” may include the following (Treas Reg §1.513–4(c)(2)(i)):

- Advertising of a payor’s products or services (including messages containing quantitative or comparative language, price information, or other indication of savings or value, an endorsement, or inducement to purchase, sell, or use any facilities, products, or services). Treas Reg §1.513–4(c)(2)(iii)(A), (c)(2)(v).
- Exclusive-provider arrangement that limits or prohibits the exempt organization’s sale, distribution, availability, or use of products, services, or facilities of the payor’s competitors. Treas Reg §1.513–4(c)(2)(iii)(B), (c)(2)(vi)(B).
- Goods, facilities, services, or other privileges. Treas Reg §1.513–4(c)(2)(iii)(C).
- Exclusive or nonexclusive rights to use an intangible asset (e.g., trademark, patent, or logo) owned by an exempt organization. Treas Reg §1.513–4(c)(2)(iii)(D).

If benefits provided by an exempt organization during a taxable year do not have an aggregate fair market value in excess of 2 percent of a payment, they are ignored. Treas Reg §1.513–4(c)(2)(ii).

Excluded from “substantial return benefits.” “Substantial return benefits” do not include the use or acknowledgment of the name or logo of the payor’s trade or business in connection with the activities of an exempt organization (including exclusive sponsorship arrangements as defined in Treas Reg §1.513–4(c)(2)(vi)(A)); logos that do not contain qualitative or comparative descriptions of the payor’s product, services, or facilities; a list of the payor’s locations, telephone number, or Internet address; value neutral descriptions, including displays or visual depictions; and the payor’s brand name or trade name and product or service listings. Treas Reg §1.513–4(c)(2)(iv).

EXAMPLE► An exempt symphony orchestra that receives financial support from a music store could state in a program guide “the concert is sponsored by the Music Shop located at 123 Main Street, telephone number 555–1234,” but it could not state “visit the Music Shop today for the finest selection of music CDs and cassette tapes.” Treas Reg §1.513–4(f), Example 8.

Level of attendance contingency. If any part of a payment is contingent on a level of attendance at one or more events, broadcast ratings, or other factors indicative of the degree of public exposure, that part will not constitute a qualified sponsorship payment. IRC §513(i)(2)(B)(i).

Fair market value of return benefit. Because a qualified sponsorship payment will be limited to the amount, if any, by which the payment or payments received exceed the fair market value of the return benefit or benefits realized by the payor, the exempt organization must establish such fair value. If a payment or part of a payment is not a qualified sponsorship, this does not mean that it necessarily is included in unrelated business taxable income. One or more other rules discussed in this chapter might apply to exclude it. For further discussion, see Woods, Tax Treatment of Corporate Sponsorship Payments to Exempt Organizations: Final Regulations, 97 J Tax 174 (2002).
§17.25  4. Statutory Exceptions and Modifications

By statute, certain activities are not considered unrelated trades or businesses. Income realized from an unrelated trade or business is also subject to certain statutory “modifications.” IRC §512(b). Some of these modifications, however, are really exceptions. See §§17.26–17.43.

§17.26  a. Use of Premiums in Soliciting Contributions

The tax on unrelated business income does not apply to distributions of low-cost articles incidental to a solicitation of charitable contributions. Treas Reg §1.513–1(b). If an organization is exempt under IRC §501(c) and donations to the organization are deductible as charitable contributions under IRC §170(c)(2) or §170(c)(3), the organization does not engage in an unrelated trade or business by distributing articles in the course of soliciting contributions as long as the following apply (IRC §513(h)):

- All articles distributed to any one person during any calendar year do not have a cost to the distributing organization of more than $10.40 for 2014 (adjusted annually for inflation; see Rev Proc 2013–35, §3.28(1), 2013–47 Int Rev Bull 537);
- The distribution is not made at the request of the distributee;
- The distribution is made without the express consent of the distributee; and
- The distribution is accompanied by both a request for a charitable contribution and a statement that the distributee may retain the article even if a contribution is not made.

However, the IRS has taken the position that the sale of items that met these criteria did not qualify under IRC §513(h) when the solicitations were often in competition with for-profit vendors, sometimes violated copyright laws, and at times were illegal. IRS Letter Ruling 9652004. For a critical comment on this ruling, see Tesdahl, UBIT Ruling Raises New Concerns for Soliciting Charities, 16 Exempt Org Tax Rev 481 (Mar. 1997).

§17.27  b. Activities Performed by Volunteers

An activity is not considered an unrelated trade or business if unpaid volunteers perform substantially all the work. IRC §513(a)(1). See Greene County Med. Soc’y Found. v U.S. (WD Mo 1972) 345 F Supp 900, disapproved on other grounds in Louisiana Credit Union League v U.S. (5th Cir 1982) 693 F2d 525 (sale of phonograph records by “Singing Doctors” not trade or business; even if it were, it would be exempt because performers were unpaid). Thus, weekly public dances held by a volunteer fire department are exempt if unpaid volunteers provide all services. Rev Rul 74–361, 1974–2 Cum Bull 159.

“Compensation” as not trifling. “Compensation,” as used in the statute, is not meant to include a “trifling inducement.” Waco Lodge No. 166 v Commissioner (5th Cir 1983) 696 F2d 372, 375. The Waco Lodge court ignored the value of free beverages furnished to otherwise uncompensated workers in determining whether work was performed without compensation. (The value of the beverages was about $2.22 per worker per night, or about $0.63 an hour.) The IRS follows the decision in Waco Lodge and applies the tests of IRC §132(e)(1) and Treas Reg §1.132–6 to determine what constitutes a trifling amount. GCM 39786 (Oct. 26, 1988).

Members of religious orders. Members of a religious order who receive food, shelter, clothing, and medical care, but who are not required to render any services to obtain such benefits, have been held to be

“Material income-producing factor” requirement. The IRS takes the position that the volunteer exception applies only if the performance of services is a material income-producing factor. It has concluded that this exception does not apply to income derived from leasing various kinds of machinery for periods of 5 to 8 years with options to renew even when the limited work in finding lessees, negotiating rental agreements, and processing rental payments is performed by volunteers. Rev Rul 78–144, 1978–1 Cum Bull 168.

Scrip sales. A program administered by uncompensated persons in which an exempt organization sells scrip to be used by purchasers to buy goods or services from retailers is not an unrelated trade or business because the volunteer exception applies. IRS Letter Ruling 9704012. See IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for 2000, p 278 (available at http://www.irs.gov/Charities-&-Non-Profits/CPE-for-FY-2000).

§17.28 c. Sale of Donated Merchandise

Selling merchandise is not an unrelated trade or business if substantially all the merchandise was received as gifts. IRC §513(a)(3). A thrift shop that sells donated articles is exempt from tax even though it is separately incorporated. Rev Rul 71–581, 1971–2 Cum Bull 236.

§17.29 d. Income From Investment Transactions—Dividends, Interest, Annuities, Royalties, and Capital Gains


In any event, dividends, interest, annuities, royalties, gains, or losses from sales or exchanges of property that is neither inventory nor held for sale to customers in the ordinary course of a trade or business (see IRS Letter Ruling 200619024, stating criteria IRS will consider in deciding whether sales of real property were made in ordinary course of trade or business) and other income from investment activities are specifically excluded from unrelated business taxable income. However, they are not excluded to the extent they (1) are derived from debt-financed property (see §§17.45–17.58) or, in certain circumstances, (2) are paid by a controlled entity or are deemed distributions from insurance income of controlled foreign corporations (see §§17.40, 17.68). IRC §512(b)(1)–(2), (4)–(5). These exclusions apply to distributions from real estate investment trusts. Rev Rul 66–106, 1966–1 Cum Bull 151. Because of these exclusions, transactions should be structured to produce one of these types of income, if possible. For example, an exempt organization’s book publication and sales may result in income taxed as unrelated business taxable income, but a royalty received from licensing publication rights to a commercial publisher would not. Rev Rul 69–430, 1969–2 Cum Bull 129. However, an exempt
organization’s attempt to classify revenues as excluded royalty income may fail if its participation in the activities creating the income is not passive or de minimis. *Arkansas State Police Ass’n v Commissioner* (8th Cir 2002) 282 F3d 556.

**Notional principal contracts.** Income from notional principal contracts and other substantially similar income from ordinary and routine investments are excluded from unrelated business taxable income, to the extent determined by the IRS. Treas Reg §1.512(b)–1(a)(1). These exclusions do not apply to income earned by brokers or dealers. Gains or losses from the sale or disposition of notional principal contracts are governed by IRC §512(b)(5). Treas Reg §1.512(b)–1(a)(2). A “notional principal contract” is defined in Treas Reg §§1.446–3(c)(1).

**Options and forfeitures.** Gains or losses recognized in connection with an exempt organization’s investment activities from the lapse or termination of options to buy or sell securities (as defined in IRC §1236(c)) or real property and gains or losses from the forfeiture of good faith deposits for the purchase, sale, or lease of real property are excluded from unrelated business taxable income. IRC §512(b)(5).

**Timber sales.** The exclusion does not apply to gains or losses recognized from timber sales described in IRC §631(a). Treas Reg §1.512(b)–1(d)(1).

**Securities loan payments.** Income from certain securities lending transactions is excluded from unrelated business taxable income. IRC §512(a)(5), (b)(1).

**Loan commitment fees.** Income from loan commitment fees is excluded. IRC §512(b)(1).

§17.30 e. Mailing List Sales

Payments received by an exempt organization from sales of its donor mailing lists have been held not to be royalty income excluded from unrelated business taxable income under IRC §512(b)(2) because that income was not derived from “passive” activities. *Disabled Am. Veterans v Commissioner* (Ct Cl 1981) 650 F2d 1178. For further discussion of the meaning of “royalty,” see *Texas Farm Bureau v U.S.* (5th Cir 1995) 53 F3d 120.

The decision in *Disabled Am. Veterans v Commissioner*, supra, has been overridden in part by IRC §513(h), which provides that, if an organization is exempt under IRC §501(c)(3) and contributions to the organization are deductible under IRC §170(c)(2) or §170(c)(3), the organization will not be considered engaged in an unrelated trade or business as a result of exchanging with, or renting to, similar organizations the names and addresses of donors or members.

§17.31 f. Royalty Income From Mailing List Rentals, Logos, Affinity Cards, and Other Intangibles

**Income from mailing list rentals.** The Tax Court has held that income derived from the rental of mailing lists constitutes royalty income excluded from unrelated business taxable income under IRC §512(b)(2). *Sierra Club, Inc.*, TC Memo 1993–199 (club was tax-exempt under IRC §501(c)(4) and thus could not rely on IRC §513(h)). The court rejected the IRS’s contention that this exclusion should be limited to “passive” royalties. The court reserved for trial the issue of the extent, if any, to which payments were received for services in connection with the rental of lists and from the sale of media on which the lists were furnished (e.g., magnetic tapes, labels), but this issue was later resolved between the parties.
**Affinity card programs.** In addition, the Tax Court has held that payments received under an affinity credit card program, which allowed financial institutions to promote their credit cards through use of the Sierra Club name, were also excluded royalty income under IRC §512(b)(2). *Sierra Club, Inc.* (1994) 103 TC 307. On appeal, the court affirmed that income from renting mailing lists was excluded royalty income but reversed the decision that income from the affinity credit card program also qualified as royalty income. *Sierra Club, Inc. v Commissioner* (9th Cir 1996) 86 F3d 1526. The court defined a “royalty” as a payment for the use of intangible property that does not represent compensation for services rendered by the owner of the property. Because the Sierra Club did not perform any services with respect to the mailing lists, the income from licensing use of the lists was royalty income. The case was remanded to the Tax Court for additional consideration about whether Sierra Club rendered services for the credit card program. On remand, the Tax Court found that no part of the amounts paid to the Sierra Club represented compensation for services. Similar conclusions were reached as to mailing list rentals in *Common Cause* (1999) 112 TC 332 and *Planned Parenthood Fed’n of Am., Inc.*, TC Memo 1999–206, and as to affinity cards in *Oregon State Univ. Alumni Ass’n v Commissioner* (9th Cir 1999) 193 F3d 1098.

**NOTE**► As a result of the above decisions adverse to its position, the IRS will no longer assert that income received from rentals of mailing lists and affinity cards is not royalty income excluded from unrelated business taxable income under IRC §512(b)(2). See 28 Exempt Org Tax Rev 18 (Apr. 2000). However, the active involvement of an exempt organization in a business activity can result in the inapplicability of the royalty exclusion. See *Arkansas State Police Ass’n v Commissioner* (8th Cir 2002) 282 F3d 556; Light, *Denial of the Royalty Exclusion Because of Excess Participation in Arkansas State Police Ass’n v Commissioner*, 55 Tax Law 351 (Fall 2001).

Income received from an insurance company by a credit union exempt from tax under IRC §501(c)(14) in consideration for the right to use the credit union’s name and membership list to solicit members was held to be excluded royalty income even though the credit union collected the premiums by debiting members’ accounts. *Bellco Credit Union v U.S.* (DC Colo 2010) 735 F Supp 2d 1286, 1305.

§17.32  g. Rental Income

Income from renting real property is not included in unrelated business taxable income unless it is derived from debt-financed property (see §§17.45–17.58) or, in certain circumstances, is paid by a controlled entity (see §17.68). IRC §512(b)(3). This rental exclusion is unavailable if the lessor renders services related to the rental property beyond those usually rendered in connection with the rental of space only. For example, supplying maid service with the rental of living quarters is a disqualifying service, but furnishing heat and light, cleaning public areas, and collecting trash are not. Treas Reg §1.512(b)–1(c)(5). When a university leased its stadium to a professional football team, the IRS ruled that providing field and grounds maintenance, dressing rooms, linen, and security constituted substantial disqualifying services. Rev Rul 80–298, 1980–2 Cum Bull 197. In *John W. Madden, Jr.*, TC Memo 1997–395, the provision of parking spaces, maintenance, and security with respect to the lease of an amphitheater did not result in loss of the rental exemption. However, parking fee income from a stand-alone parking lot has been held not to qualify for the rental exclusion. *Ocean Pines Ass’n, Inc.* (2010) 135 TC 276, aff’d (4th Cir 2012) 672 F3d 284.

**PRACTICE TIP**► It may be possible to avoid rental income being taxable as a result of services being rendered in conjunction with the rental of real property either by demonstrating that the services
were not for the convenience of the lessee or by separately charging for services. See IRS Letter Ruling 9835001.

The rental exclusion is also unavailable if the rent is set wholly or in part by reference to the income or profits realized by any person from the leased property (other than an amount based on a fixed percentage or percentages of receipts or sales). IRC §512(b)(3)(B)(ii).

§17.33 (1) Personal Property Included

The exclusion from unrelated business taxable income is also unavailable if personal property is leased with the real property and more than 50 percent of the total rental income is attributable to the personal property. IRC §512(b)(3)(B)(i). If the rent attributable to the personal property is an incidental part (i.e., no more than 10 percent of the total), the exclusion is available for the rent allocable to both the real and personal property. Treas Reg §1.512(b)–1(c)(2)(ii). If the rent attributable to the personal property is more than 10 percent but less than 50 percent of the total, the exclusion is available for the rent allocable to the real property but not the personal property. Both the 10-percent test and the 50-percent test are applied on the lessee’s initial use, on certain additions to or replacements of personal property, and on modifications of the rental price. Treas Reg §1.512(b)–1(c)(3)(iv)–(v).

§17.34 (2) Rental for Business Operations

An exempt organization might receive a greater return by renting real property on a tax-free basis than by operating a business on the property if the income from the business would be taxable. For example, income derived by a charitable organization from operating farms and orchards is taxable as unrelated business income, but rental income from a tenant on such property is not. U.S. v Myra Found. (8th Cir 1967) 382 F2d 107.

Despite the foregoing, if a facility is purchased with proceeds from a private activity bond that at the time of issue purported to be a qualified IRC §501(c)(3) bond (see §18.12), and if any portion of such facility is used by a person other than an organization exempt under IRC §501(c)(3) or a government unit, then a §501(c)(3) organization owner of such portion will be treated as engaged in an unrelated trade or business with respect to such portion. The resulting rental income received by the §501(c) organization will be taxed as unrelated trade or business income. For this purpose, the owner’s gross income will not be less than fair rental value, and no deduction is allowed for interest on loans financed from bond proceeds. IRC §150(b)(3).

Under California law, rental income received directly or indirectly from one tax-exempt church by another tax-exempt church for rental of exempt-function church property is excluded from unrelated business taxable income. Rev & T C §23741.

§17.35 h. Trade Shows, State Fairs, and Similar Activities

Certain activities relating to trade shows, state fairs, and similar events are not treated as unrelated trades or businesses. IRC §513(d).
§17.36 i. Bingo Games and Gambling

Conducting bingo games in accordance with state or local law is not treated as an unrelated trade or business if (IRC §513(f))

- The games are of a type in which wagers are usually placed, winners determined, and prizes distributed in the presence of all persons placing wagers; and
- The games are ordinarily not conducted on a commercial basis.

If these conditions are not met, a regularly conducted gambling activity, including bingo, is an unrelated trade or business. See Executive Network Club, Inc., TC Memo 1995–21. In this exception, “bingo” is defined to mean a game of chance in which numbers corresponding to preprinted numbers on a card are called according to random selection to player participants; thus, games using instant bingo cards are excluded from the definition. Julius M. Israel Lodge of B’nai B’rith v Commissioner (5th Cir 1996) 98 F3d 190. See IRS Publication No. 3079 (Tax-Exempt Organizations and Gaming) for various rules pertaining to gaming activities by tax-exempt organizations.

§17.37 j. Income From Research

Income from and deductions relating to research are excluded from unrelated business taxable income if the research is performed for

- Any governmental agency (IRC §512(b)(7));
- Any person by a college, university, or hospital (IRC §512(b)(8)); or
- Any person by an organization operated primarily to conduct fundamental research, the results of which are freely available to the public (IRC §512(b)(9)).

NOTE► The regulations state that “the term ‘research’ does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.” Treas Reg §1.512(b)–1(f)(4). The validity of the “testing” aspect of this regulation is doubtful. See H Rep No. 2319, 81st Cong, 2d Sess (1950), reprinted in 1950–2 Cum Bull 409. See also Midwest Research Inst. v U.S. (WD Mo 1983) 554 F Supp 1379, aff’d (8th Cir 1984) 744 F2d 635 (questioning validity of language in Treas Reg §1.501(c)(3)–1(d)(5)(ii) pertaining to “ordinary testing,” which language is identical to that in Treas Reg §1.512(b)–1(f)(4)).


§17.38 k. Activities for Convenience of Persons Related to Certain Organizations

Organizations described in IRC §501(c)(3), public colleges and universities, and certain employees’ associations, may carry on activities primarily for the convenience of their members, students, patients, officers, or employees without having those activities considered unrelated trades or businesses. IRC
§513(a)(2). Thus, a laundry operated by a university for the convenience of its students, officers, and employees is exempt from taxation. Rev Rul 55–676, 1955–2 Cum Bull 266.

§17.39  I. Services Rendered Between Unrelated Hospitals

Fees received by one exempt hospital for rendering services to an unrelated exempt hospital are not treated as income from an unrelated trade or business if (IRC §513(e))

- The hospital receiving services has no more than 100 inpatients;
- The services would be exempt activities if performed by the hospital on its own behalf; and
- The services are provided for a fee that does not exceed the actual cost of providing the service, including straight-line depreciation and a reasonable amount for return on capital goods used to produce such services.

§17.40  m. Insurance Income of Controlled Foreign Corporation

A United States shareholder, including an exempt organization, is deemed to receive as dividends its prorata share of certain types of income earned by certain controlled foreign corporations. IRC §§951–954. Any such dividend income that is attributable to the writing of insurance that would have been taxed as unrelated business income if the insurance activity had been carried on directly by the exempt organization is included in unrelated business taxable income. However, these types of dividends are not included: dividends attributable to insurance with respect to which the person insured is the tax-exempt organization, its tax-exempt affiliates, and a director or officer of the organization, or individuals who perform services for the organization if the insurance covers primarily risks associated with the performance of services for the exempt organization or its affiliates. IRC §512(b)(17).

§17.41  n. Dues Paid to Agricultural and Horticultural Organizations

Annual dues not exceeding $100 (indexed for inflation) paid by members of an agricultural or horticultural organization described in IRC §501(c)(5) are not taxed as unrelated business taxable income as a result of benefits being conferred on those members by the organization. IRC §512(d). The amount is $158 for 2014. Rev Proc 2013–35, §3.27, 2013–47 Int Rev Bull 537. Subject to IRC §512(d), the IRS will treat as unrelated business income dues from associate members if the associate member category has been formed or availed of for the principal purpose of producing revenue rather than furthering the organization’s exempt purposes. Rev Proc 97–12, 1997–1 Cum Bull 631.

§17.42  o. Sales of Inventory Acquired From Certain Financial Institutions

Income from sales and mortgages of real property held primarily for sale to customers in the ordinary course of a trade or business is excluded from unrelated business taxable income if such real property was acquired under limited conditions from certain financial institutions in economic distress. Generally, for the income to be excluded, the property must be designated for sale within 9 months after its acquisition and sold within 30 months after acquisition. No more than half of property acquired in a single transaction may be so designated, and the amount spent on improvements and development may not exceed 20 percent of the net selling price. IRC §512(b)(16).
§17.43  p. Disposition of Brownfield Properties

Gain or loss from the sale or exchange of certain narrowly defined brownfield properties (i.e., environmentally damaged properties) is excluded from unrelated trade or business income. IRC §512(b)(19). This exclusion is discussed in Brewer & Hibbs, The Brownfield Exemption from the Unrelated Business Income Tax, 18 Tax’n Exempt Orgs 109 (Nov./Dec. 2006). Special deduction recapture rules may apply to the sale. IRC §198(e).

§17.44  5. Internet Activities

At one point, Internet activities by tax-exempt organizations attracted the attention of the IRS, which had been conducting an apparently ongoing study to determine whether such activities will result in unrelated business taxable income. Some of the issues that troubled the IRS are identified in the IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for 2000, pp 131–140 (available at http://www.irs.gov/Charities-&-Non-Profits/CPE-for-FY-2000). The IRS asked for comments on the subject in IRS Announcement 2000–84, 2000–2 Cum Bull 385.

Material published electronically. Treasury Regulation §1.513–4(b) provides that “printed material” includes “material that is published electronically,” indicating that, in the opinion of the IRS, Internet activity under certain circumstances is equivalent to a periodical in which advertising can appear. For purposes of IRC §513(i), a mere hyperlink on an exempt organization’s website to a sponsor’s website is an acknowledgment that does not constitute a substantial return benefit to the sponsor, and payment for it is thus a qualified sponsorship payment. Treas Reg §1.513–4(f), Example 11. See §17.24. However, if there is a hyperlink to the sponsor’s website where an endorsement of the sponsor’s product by the exempt organization appears that was reviewed and approved by the exempt organization, this constitutes advertising. Treas Reg §1.513–4(f), Example 12.

Providing free hyperlinks. In IRS Letter Ruling 200303062, the IRS ruled that an agricultural organization exempt under IRC §501(c)(5) that provided free links on its website to the websites of third parties who provide services to its members was not engaged in an unrelated trade or business as a result of this activity, providing these links were not services that would cause a portion of the royalty payments to be taxable (see §17.31), and the sale of banner advertising on the organization’s website was not advertising under Treas Reg §1.512(a)–1(f) as long as it was not included in an online periodical.

Charging fee for website listing. Revenue Ruling 2004–112, 2004–2 Cum Bull 985, involved two different situations with respect to website activities of a trade association exempt under IRC §501(c)(6). In the first situation, the association, as one of its substantial exempt activities, conducted a 10-day semiannual trade show. During that 10-day period and for the 3 days before and after, the organization added a section to its website posting information available at the trade show, links to visual exhibits, order forms, and an online purchasing arrangement. Exhibitors were charged a fee for website listings. The IRS held that these website activities constituted “qualified convention and trade show activities” and that the fees were thus excluded from unrelated business treatment by IRC §513(d)(3)(B). See §17.35.

Providing virtual trade show. In the second situation, for a 2-week period that had no connection to any actual trade show or other activity, the exempt trade association maintained a website that contained product information, displays, listings, order forms, an online purchasing arrangement, and links to the organization’s members as well as to suppliers to its members. Those who listed information on the website were charged a fee. The IRS held that this virtual trade show was not a qualified convention or trade show activity and thus would have to be tested under the normal rules used to determine whether an
activity is an unrelated trade or business. In the author’s opinion, the trade association could make a
strong argument that this activity furthered its exempt purpose and was thus not an unrelated trade or
business. See §17.23.

§17.45 D. Unrelated Debt-Financed Income

If an exempt organization derives income from debt-financed property (see §§17.46–17.49), all or part
of that income may be taxed as unrelated business income (see §§17.50–17.58). IRC §514(a). This
provision overrides several exceptions that would otherwise apply in determining whether an organization
has unrelated business income, including the exceptions for interest, dividends, royalties, rents from real
property, and capital gains. The debt-financed income rules should be considered whenever an exempt
organization borrows funds to acquire or improve an asset or acquires an encumbered asset or acquires an
interest in a partnership or limited liability company (LLC) that borrows funds to acquire property. See
§§17.73–17.74. For example, securities purchased on margin are debt-financed property and thus part of
the dividends from the securities and gains realized on their sale is taxable. Henry E. & Nancy Horton
Bartels Trust v U.S. (Fed Cir 2010) 617 F3d 1357. Interest earned on borrowed funds is also taxed. Kern
County Elec. Pension Fund (1991) 96 TC 845, aff’d (9th Cir 1993) 988 F2d 120. The debt-financed
income rules generally apply to encumbered property received by an exempt organization as a gift or
bequest as well as when an exempt organization borrows to acquire property. See §17.52. The debt-
financed income rules are thoroughly discussed in two related articles: McDowell, What You Need to
Know About the Unrelated Debt-Financed Income Rules, 14 J Tax’n Exempt Orgs 206 (Mar./Apr. 2003);
McDowell & Abrams, Applying the Unrelated Debt-Financed Income Rules to Investments in Real
Property, 15 J Tax’n Exempt Orgs 3 (July/Aug. 2003).

§17.46 1. Debt-Financed Property Defined

“Debt-financed property” is property (1) that is held to produce income and (2) with respect to which
there is acquisition indebtedness (see §§17.51–17.55) at any time during the taxable year (or, if the
property is disposed of during the taxable year, at any time during the preceding 12 months). IRC
§514(b)(1). Income includes nonrecurring income such as capital gains. Treas Reg §1.514(b)–1(a).

Income from a short sale through a broker is not debt-financed when borrowed funds are not used as
collateral or to acquire the securities that were used to cover the short sale. Rev Rul 95–8, 1995–1 Cum
Bull 107.

§17.47 a. Property Used in Connection With Exempt Purposes

Property is not considered debt-financed property if substantially all its use is related (other than
through production of income) to the exercise or performance of the organization’s exempt purposes or
functions. IRC §514(b)(1)(A)(i). “Substantially all its use” means at least 85 percent, measured by time or
space. Treas Reg §1.514(b)–1(b)(1)(ii). Property is not considered to be debt-financed if it is acquired for
use in an activity that itself is not subject to the unrelated trade or business tax by virtue of IRC
§513(a)(1) (activities in which substantially all the work is performed without compensation; see §17.27),
§513(a)(2) (activities for the benefit of members, students, patients, officers, or employees; see §17.38),
§513(a)(3) (selling merchandise received as gifts; see §17.28), or §512(b)(7)–(9) (certain research; see
§17.37).
If property owned by an exempt organization is used by a related organization, it is treated for the above purposes as if used by the organization that owns it. IRC §514(b)(2). Basis, indebtedness, income, and deductions are allocated if the property is used for one of the above purposes and also for other purposes. IRC §514(e); Treas Reg §1.514(c)–1. Real property leased to a medical clinic to accomplish the lessor’s exempt purposes is not treated as debt-financed property. IRC §514(b)(1); Treas Reg §1.514(b)–1(c)(1).

§17.48   b. Property Used in Unrelated Trade or Business

If property that would otherwise be considered debt-financed property is used in an unrelated trade or business, income from the property is already taxed as unrelated business taxable income and is thus excepted from debt-financed property to the extent of that unrelated business taxable income. This exception thus does not apply to gain realized from the sale of an asset used in an unrelated trade or business to the extent that it is excluded from unrelated business taxable income under IRC §512(b)(5). IRC §514(b)(1)(B); Treas Reg §1.514(b)–1(b)(2)(i).

§17.49   c. Property Near Existing Facility

Property that is purchased in the “neighborhood” of an existing facility used for an exempt purpose (e.g., a hospital) and that is to be used in conjunction with that facility within 10 years is exempt from debt-financed property treatment for that 10-year period if, after 5 years, the IRS finds that the intended use will occur within that period. IRC §514(b)(3); Treas Reg §1.514(b)–1(d). This exemption applies only to land and existing buildings to be demolished and does not apply to structures erected on land after it is acquired. IRC §514(b)(3)(C); Treas Reg §1.514(b)–1(d)(3). To be in the “neighborhood,” the property being acquired must be contiguous to the existing facilities or, if no contiguous property is available, within one mile of the facilities. Treas Reg §1.514(b)–1(d)(1)(ii).

For churches, the 10-year period is extended to 15 years and the property being acquired need not be in the neighborhood. IRC §514(b)(3)(E).

2. Determining Debt-Financed Income Subject to Tax

§17.50   a. Basic Formula

Unrelated business taxable income includes part of the income from debt-financed property. This portion (not exceeding 100 percent) is determined each year by applying the ratio of that year’s average acquisition indebtedness relating to the property (see §17.56) to its average adjusted basis for the year (see §17.57). IRC §514(a)(1).

(1) What Is Acquisition Indebtedness?

§17.51   (a) General Test

“Acquisition indebtedness” generally means (IRC §514(c)(1))

- Indebtedness incurred in acquiring or improving debt-financed property;
Indebtedness incurred before the acquisition or improvement of such property if the indebtedness would not have been incurred but for the acquisition or improvement, whether it is incurred before or after the acquisition or improvement; and

Indebtedness incurred after the acquisition or improvement of such property if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.

§17.52 (b) Property Acquired Subject to Indebtedness

If an organization acquires property subject to a mortgage or other lien, the amount of the mortgage or lien is treated as an indebtedness incurred to acquire the property even though the organization does not assume or agree to pay the indebtedness. IRC §514(c)(2)(A). This rule applies to a property tax lien only after it has become due and payable and the owner has had an opportunity to pay it. IRC §514(c)(2)(C).

The rule does not apply to property acquired by bequest or devise during the 10-year period following acquisition, nor does it apply to property acquired by gift for the 10-year period following the gift if the donor had held the property for more than 5 years and the debt is more than 5 years old. These exceptions do not apply if the transferee assumes the debt obligation or pays for an equity interest in the transferred property. IRC §514(c)(2)(B).

§17.53 (c) Effect of Terminating Exempt Purpose of Property

If property subject to an indebtedness ceases to be used for an exempt purpose and thus becomes debt-financed property, the debt on the property becomes acquisition indebtedness. Treas Reg §1.514(c)–1(a)(3). If property used for an exempt function is sold, indebtedness relating to that property is not paid off, and the proceeds are used to purchase debt-financed property, then the retained indebtedness becomes acquisition indebtedness with respect to the new property. Treas Reg §1.514(c)–1(a)(4).

§17.54 (d) Exclusions

Acquisition indebtedness does not include indebtedness that is inherently incurred to further an exempt function, such as that incurred by a credit union in accepting deposits from its members. IRC §514(c)(4). It does not include an obligation to pay certain annuity contracts (IRC §514(c)(5)), nor does it include an obligation to finance the purchase, rehabilitation, or construction of housing for low- and moderate-income persons to the extent insured by the Federal Housing Administration (IRC §514(c)(6)).

Organizations described in IRC §170(b)(1)(A)(ii) (educational institutions having a regular curriculum, faculty, and student body) and certain affiliates of those organizations enjoy a limited exclusion for indebtedness relating to acquisitions of real property. IRC §514(c)(9).

Acquisition indebtedness does not include indebtedness on brownfield (i.e., environmentally damaged) property excluded under IRC §512(b)(8) and §514(b)(1)(E). See §17.43.

Organizations described in IRC §501(c)(25) (small trusts or corporations organized solely to invest in, hold, collect, and pay income from real property) enjoy a limited exclusion from acquisition indebtedness under IRC §514(c)(9). This exclusion may be effectively used, through the holding of interests in an organization exempt under IRC §501(c)(25), only by exempt organizations described in IRC §170(b)(1)(A)(ii) or by qualified pension trusts. IRC §514(c)(9)(F).
California law generally conforms to IRC §514. Rev & T C §23735.

§17.55  (e) Burden of Debt Not on Exempt Organization

Debt-financed property rules might not apply if the burden of the debt falls on another entity. See Rev Rul 70–132, 1970–1 Cum Bull 138; Rev Rul 76–95, 1976–1 Cum Bull 172. For example, debt-financed property might not exist under the following set of conditions (see IRS Letter Ruling 8317126):

- An exempt organization owns unimproved, unencumbered real property;
- It leases the property to an entity that erects a building on the property;
- The funds for construction are borrowed from a lender that insists that the exempt organization’s fee interest be subordinated to the deed of trust securing the lender’s loan; and
- The mortgage term is less than the lease term.

§17.56  (2) Determining Average Acquisition Indebtedness

Average acquisition indebtedness during a tax year other than a year in which the property is sold is the average of the amounts of acquisition indebtedness with respect to a property on the first day of each calendar month of that year during which the property is held. For the year the property is sold, it is the highest amount of acquisition indebtedness with respect to the property during the 12 months preceding the sale. IRC §514(c)(7); Treas Reg §1.514(a)–1(a)(1)(v), (a)(3). If property is acquired for an indeterminate price, the initial acquisition indebtedness is its fair market value on the date of acquisition less any initial principal payment. Treas Reg §1.514(a)–1(a)(4)(iii).

§17.57  (3) Determining Average Adjusted Basis

Average adjusted basis is the average of the adjusted bases of a property on the first day of the taxable year and the last day in the taxable year on which the property is held. Treas Reg §1.514(a)–1(a)(3)(ii). If property is acquired for an indeterminate price, its unadjusted basis is its fair market value. Treas Reg §1.514(a)–1(a)(4)(ii). In determining adjusted basis, straight-line depreciation is used and must be treated as taken for all years during which the property is held. IRC §514(a)(3); Treas Reg §1.514(a)–1(a)(2)(ii).

§17.58  b. Offsetting Direct Expenses of Debt-Financed Property

Expenses directly connected with debt-financed property or with the income from that property may be used to offset the income from the property by applying the ratio of that year’s average acquisition indebtedness relating to the property’s average adjusted basis for the year to those expenses. These expenses include straight-line depreciation and the dividends-received deductions set forth in IRC §§243–245. IRC §514(a)(2)–(3); Treas Reg §1.514(a)–1(b).

§17.59  E. Computing Tax on Unrelated Business Income

Tax is levied on unrelated business taxable income derived by an exempt organization from any unrelated trade or business, less allowable deductions directly connected with carrying on the business, subject to certain modifications. IRC §512(a)(1).
Social clubs, voluntary employees’ beneficiary associations, supplemental employment plan trusts, and group legal service plan associations may generally deduct only expenses directly connected with taxable income (see §17.60), charitable contributions (see §17.61), a $1000 specific deduction (see §17.62), and net operating losses (see §17.63). IRC §512(a)(3). They cannot take deductions under IRC §§243–245 for dividends received. *Rolling Rock Club v U.S.* (3d Cir 1986) 785 F2d 93. Other special rules apply to foreign organizations (IRC §512(a)(2)) (but California law does not have a similar position; see Rev & T C §23732) and to veterans associations (IRC §512(a)(4)).

Internal Revenue Code §448 requires C corporations with annual gross receipts of $5 million or more to use the accrual method of accounting for income tax reporting purposes. Temporary Regulation §1.448–1T(a)(3) takes the position that this requirement applies to exempt corporations and trusts with unrelated business taxable income. The $5 million test is applied to gross receipts from activities that constitute an unrelated trade or business. Temp Treas Reg §1.448–1T(f)(2). For these purposes, an exempt trust with unrelated trade or business activities is treated as a C corporation. IRC §448(c)(6).

1. Expenses and Deductions

§17.60 a. Expenses Attributable to Unrelated Business

Expenses (including depreciation) attributable solely to unrelated business activities are chargeable against unrelated business income. Treas Reg §1.512(a)–1(b). If facilities are used both to conduct an unrelated trade or business and to carry on other activities, expenses (including administrative overhead) must be allocated between the two uses on a reasonable basis. Treas Reg §1.512(a)–1(c). Allocation of fixed overhead expenses on the basis of actual time used for the respective activities is reasonable. *Rensselaer Polytechnic Inst.* (1982) 79 TC 967, aff’d (2d Cir 1984) 732 F2d 1058 (court rejected IRS contention that fixed overhead must be allocated by ratio of hours of use over total number of hours in year).

Expenses incurred in exploiting an exempt activity, such as advertising in a magazine published to further an organization’s exempt purposes, may require a special and more complex allocation. See Treas Reg §1.512(a)–1(d)–(f). See also Treas Reg §1.513–1(d)(4)(iv), Examples 5–7. For discussion of the rules applied in computing unrelated business income realized from advertising, see *American Med. Ass’n v U.S.* (7th Cir 1989) 887 F2d 760. As a general rule, unrelated business income derived from advertising in periodicals equals gross advertising income less (1) direct advertising costs and (2) any amount by which readership costs exceed circulation income. If members of an organization have a legal right to receive a periodical published by that organization, a portion of the members’ dues must be allocated to circulation income. *National Educ. Ass’n of U.S.* (2011) 137 T C 100.

Social clubs exempt under IRC §501(c)(7) may offset losses from the sale of services to nonmembers against investment income only if the nonmember sales were motivated by an intention to make a profit. An exempt organization must use the same allocation method to determine whether a profit intent exists as it uses to compute its actual profit or loss. *Portland Golf Club v Commissioner* (1990) 497 US 154, 110 S Ct 2780. A social club may deduct from advertising income the editorial expenses of a magazine distributed free of charge to its members. *Chicago Metro. Ski Council* (1995) 104 TC 341.
§17.61  b. Charitable Deduction

A charitable deduction (IRC §170) is allowable, subject to a ceiling for corporations of 10 percent of unrelated business income. IRC §512(b)(10). An exempt trust is subject to the percentage ceilings of IRC §170(b)(1)(A)–(B) applied to its unrelated business taxable income. Distribution to a beneficiary of an exempt trust is treated as a charitable contribution if the beneficiary is an exempt organization. IRC §512(b)(11).

§17.62  c. Specific Deduction

A specific deduction of $1000 is allowed, but it may not be taken in computing a net operating loss. Special rules allow multiple deductions for local units of certain religious organizations. IRC §512(b)(12).

§17.63  d. Net Operating Loss

A net operating loss carryover is allowable as a deduction, but losses are only carried over to or from years in which the organization is subject to the unrelated business income tax even though all years are counted in determining the carryover period. IRC §512(b)(6).

2. Rate of Tax

§17.64  a. Basic Rate

The corporate tax rates apply to the unrelated business taxable income of exempt organizations that are corporations. IRC §511(a)(1); Rev & T C §23731(a). The tax rates applicable to trusts apply to the unrelated business taxable income of exempt trusts. IRC §511(b)(1); Rev & T C §23731(b). For California income tax purposes, however, a trust exempt under Rev & T C §23701d is treated as a corporation. See §17.13. Income from an insurance business that is an unrelated trade or business is taxed under IRC §§801–848. See §17.19.

§17.65  b. Alternative Minimum Tax

When an exempt organization computes its alternative minimum tax liability, the base for that tax is the organization’s unrelated business taxable income. IRC §55(b)(2); Rev & T C §23455(b).

§17.66  c. Returns and Estimated Taxes

Federal and California tax returns (IRS Form 990-T and FTB Form 109, respectively) must be filed for years in which a tax-exempt entity has unrelated business taxable income. For taxable years beginning after 2006, the public inspection and disclosure rules applicable to Form 990 are also applicable to Form 990-T. See §11.51. Federal and California estimated taxes must be paid on unrelated business taxable income. See Instructions for FTB Form 109.
§17.67  F. Effect of Unrelated Business Income on Exempt Status

“Reasonably commensurate” concept. Unrelated business income is not only taxable; it may have a worse result. Too much of such income might prevent an organization from qualifying for exempt status. An organization will be denied an IRC §501(c)(3) exemption if it is “organized and operated for the primary purpose of carrying on an unrelated trade or business.” Treas Reg §1.501(c)(3)–1(e). This limitation is often misinterpreted by incorrectly equating “activity” with “purpose.” The IRS has long been applying the principle that an organization’s tax-exempt status under IRC §501(c)(3) will not be jeopardized as long as it maintains an exempt program that is reasonably commensurate with its financial resources.

In IRS Letter Ruling 9711003, exemption was not denied when over 95 percent of an organization’s income was derived from a nonexempt activity, because its primary purpose was charitable. Applying the commensurate concept, the IRS did not revoke the IRC §501(c)(3) exempt status of an organization whose sole activities were conducting bingo games not subject to unrelated business income tax and distributing profits to other charitable organizations. The rationale for the commensurate concept is discussed in Troyer, Unrelated Trade or Business: Current Developments and Amount of UBIT Compatible with Charitable Exemption, 20 NYU Conf on Tax Planning for 501(c)(3) Organizations §§10.03–10.06 (1992). For a discussion of the erratic way in which this concept has evolved, see Siegel, Commensurate in Scope: Myth, Mystery or Ghost? (Part One), 20 Taxation of Exempts 26 (Nov./Dec. 2008) and (Part Two), 20 Taxation of Exempts 8 (Jan. 2009). See also Hill & Mancino, Taxation of Exempt Organizations ¶21.03[1][a] (2002 B Supp 2013–2).

It is not known if and to what extent the IRS will apply the commensurate concept to exempt organizations other than those described in IRC §501(c)(3). The IRS has demonstrated that it will not employ that concept in deciding whether a labor organization qualifies for exemption under IRC §501(c)(6). See Associated Master Barbers & Beauticians (1977) 69 TC 53 (involving IRC §501(c)(6) organization).

When concept inapplicable. This concept, however, may not be applied by the IRS when an organization obtains its IRC §501(c)(3) exemption under the “integral part” theory as a result of its close relationship with another such organization. GCM 39684 (Dec. 10, 1987).

Business leagues. Exempt status under §501(c)(6) can be lost as a result of too much unrelated business taxable income. Unfortunately, however, there is no definitive test for determining how much is too much. Treasury Regulations pertaining to §501(c)(6) organizations provide as follows (Treas Reg §1.501(c)(6)–1):

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of kind ordinarily carried on for profit … An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self sustaining, is not a business league.

Thus, there is an initial question of whether an organization’s purpose is to “engage in a regular business of a kind ordinarily carried on for profit.” Some courts have found that a business operation that is only “incidental” to a §501(c)(6) purpose will not result in loss of exemption. See Retailers Credit Ass’n v Commissioner (9th Cir 1937) 90 F2d 47. A review of authorities reveals no bright-line test for how much unrelated business taxable income is too much. See Hill & Mancino, Taxation of Exempt Organizations, 14.02[10] (2002 B Supp 2013–2).
The Ninth Circuit affirmed the IRS’s denial of exempt status to a purported §501(c)(6) business league, concluding that Bluetooth is a business, not a business league. *Bluetooth SIG v U.S.* (9th Cir 2010)611 F3d 617.


**Title-holding organizations.** By their very nature, title-holding organizations exempt under IRC §501(c)(2) or §501(c)(25) are limited in the extent to which they may engage in a trade or business other than holding title to property and collecting income from it, and the only property that an IRC §501(c)(25) organization may hold is real property. An IRC §501(c)(2) organization may have unrelated business taxable income consisting of debt-financed income (see §17.45), income received from controlled entities (see §17.68), and rents from personal property leased with real property (see §17.32). Treas Reg §1.501(c)(2)–1. Internal Revenue Code §501(c)(2) and (c)(25) organizations may receive unrelated business taxable income that would otherwise result in loss of exempt status of up to 10 percent of gross income for any taxable year as long as it is incidentally derived from the holding of real property. Exemption will be lost to such an organization if disqualifying unrelated business taxable income exceeds 10 percent of gross income unless the IRS is convinced that the receipt of such income was inadvertent and the organization takes steps to prevent a recurrence. IRC §501(c)(25)(G).

**Commercial type insurance providers.** An organization cannot qualify if a substantial part of its activities consists of providing “commercial type” insurance. IRC §501(m).

**§17.68 VI. OPERATING BUSINESS THROUGH ANOTHER ENTITY—CONTROLLED ENTITIES**

**Tax classification of other entity.** Rather than carrying on a business as a proprietorship, a tax-exempt corporation may decide to control or own all or a part of that business through another entity that under state law is a corporation, a partnership, or a limited liability company. The tax status of an entity other than a corporation is determined under the income tax laws and not state corporate, partnership, or limited liability company laws. For example, a limited partnership could be taxed as a corporation. This tax status will control how income distributable to or received by an exempt corporation from such an entity is taxed to the exempt corporation. In addition, the tax liability of the other entity may be affected by the ownership of an interest in the entity by an exempt corporation. Therefore, if a choice of tax classification is available, the tax consequences should be carefully weighed before choosing. See ABA Panel Discussion, The Intended and Unintended Effects of the Check-the-Box Regulations on Tax-Exempt Organizations, 17 Exempt Org Tax Rev 46 (July 1997); Fritz, *Structuring Joint Ventures Between for Profit and Nonprofit Organizations*, 9 J Tax’n Exempt Orgs 259 (May/June 1998).

**Taxation of income from other entity.** Despite the general exclusion of interest, annuities, royalties, and rent from unrelated business taxable income, if an exempt organization receives or accrues any such income directly or indirectly from a controlled organization, that income will be partially or entirely included in the unrelated business taxable income of the controlling organization to the extent that the payment of those amounts reduces the net unrelated income or deemed unrelated net income (or increases
any net unrelated actual or deemed loss) of the controlled entity. IRC §512(b)(13). Expenses incurred by
the controlling organization that are directly connected to such income may be deducted.

If the controlled entity is tax-exempt, its net unrelated income is the amount of its unrelated business
taxable income. If the controlled entity is not tax-exempt, its net unrelated income is considered to be that
portion of its income that would be unrelated business taxable income if it were tax-exempt and had the
same exempt purposes as the controlling organization.

NOTE► “Control” means ownership (by vote or value) of more than 50 percent of the stock of a
corporation, the profits or capital interests of a partnership, or the beneficial interests of any other
entity.

The constructive ownership rules of IRC §318 apply so that an exempt organization may be considered to
own stock and other interests not only directly but also indirectly through others.

Effect of PPA. The Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780), as amended
by Pub L 110–343, §306(a), 122 Stat 3765, temporarily modified the rules with respect to payments
received or accrued by a controlling corporation after December 31, 2005, and before January 1, 2014 (as
currently extended), when the payments were made under a contract in effect on August 17, 2006 (the
date the PPA was enacted), or under a contract renewed on substantially similar terms. Pursuant to the
PPA revision, the rules discussed above apply only to the portion of such a payment received or accrued
in a taxable year that exceeds the amount of the payment that would have been paid or accrued if the
payment had been determined under the principles of IRC §482. IRC §512(b)(13)(E)(i). Generally stated,
§482 allows the IRS to reallocate income, deductions, and other items arising as a result of transactions
between related organizations on the basis of fair market values determined by market analyses. For
example, if a controlled tax-exempt corporation paid rent to a controlling tax-exempt organization, only
the amount of the rent that exceeded fair rental value was taxable as unrelated business income to the
controlling organization under the modified rule. However, there was an additional 20-percent tax on the
lower of (1) such excess determined without regard to any amendment or supplement to a return of tax or
(2) such excess determined with regard to all amendments and supplements. IRC §512(b)(13)(E)(ii).

§17.69 A. Operating Through Corporations

Dividend income, interest, annuities, royalties, and rent, except for certain deemed distributions of
insurance income from a controlled foreign corporation (see §17.40) and except to the extent that the
controlled entity rules (see §17.68) apply, and subject to the debt-financed property rules (see §§17.45–
17.49), are excluded from unrelated business taxable income.

Income received by one exempt corporation as a result of rendering services or selling goods to another
exempt corporation is not taxable to the former if both corporations are part of a controlled group. Treas
Reg §1.502–1(b); Rev Rul 68–26, 1968–1 Cum Bull 272.

Distributions to an exempt organization by a taxable corporation controlled by the exempt organization
are dividends, not charitable contributions deductible to the distributing corporation. Dave Inv. Co., TC
Memo 1970–291 aff’d (9th Cir 1972) 462 F2d 1373; Richardson Carbon & Gasoline Co. v U.S. (5th Cir
§17.70 1. S Corporations

An organization exempt under IRC §501(c)(3) may be a shareholder in an S corporation without terminating the S status of that corporation. IRC §1361(c)(6). All income realized by a §501(c)(3) organization as a result of its being a shareholder of an S corporation is taxable as unrelated business taxable income even if the income consists of dividends, royalties, interest, rents, and capital gains earned by the S corporation. While all income allocated from an S corporation is unrelated business income, the for-profit activities of the S corporation are not attributed to the tax-exempt shareholder in regards to its tax-exempt status. IRS Letter Ruling 201328035.

Gains and losses realized by an exempt organization on the sale of an S corporation’s stock are also taxable as unrelated business taxable income, notwithstanding the general exclusion from capital gains set forth in IRC §512(b)(c).

As a result, it could be preferable for an IRC §501(c)(3) organization to be a partner in a partnership, rather than a shareholder of an S corporation, because dividends, interest, royalties, some rents, and capital gains passed through a partnership to a exempt corporation partner are not taxable unless they are derived from debt-financed property. See §17.73.

§17.71 2. Liquidation and Reorganization of Taxable Subsidiary Corporation

No gain or loss is recognized to a subsidiary corporation on its distribution of property in liquidation into a parent corporation owning at least 80 percent of the subsidiary’s stock. IRC §337(b)(2). However, if the parent corporation is tax-exempt, this general rule does not apply unless the parent immediately uses the property in an unrelated trade or business. If the parent does so, it will realize taxable gain when it later disposes of the property or ceases to use it in an unrelated trade or business. The amount of that taxable gain will be the gain that would have been realized when the subsidiary was liquidated had a tax applied at that time.

Subject to certain exceptions or limitations applicable to homeowners’ associations exempt under IRC §528, mutual or cooperative companies exempt under IRC §512(c)(12), political organizations described in IRC §527, social clubs exempt under IRC §512(c)(7), and property and casualty insurance companies exempt under IRC §512(c)(15), a taxable corporation will recognize gain or loss, immediately before the transfer as if the assets were sold for their fair market value, if it transfers all or substantially all its assets to a tax-exempt entity or converts from a taxable corporation to a tax-exempt entity. Treas Reg §1.337(d)–4.

These rules lay a potential trap for an exempt organization that is considering operating an unrelated trade or business through a taxable subsidiary. For example, if a taxable subsidiary operates a hotel, a tax will be paid on any capital gains realized by it when it disposes of the hotel. Had the exempt parent itself owned and operated the hotel, it would have paid no tax on gain from the sale except to the extent of any debt-financed income. For a discussion of debt-financed income, see §§17.45–17.49.

§17.72 3. Attributing Activities of Taxable Corporation to Exempt Organization

Ownership of equity interest. An exempt organization’s mere ownership of a controlling equity interest in a taxable corporation will not jeopardize the tax-exempt status of the exempt organization. Over the years, the IRS has issued hundreds of rulings recognizing this fact. The only ways that such a relationship might have an adverse impact on the exempt organization is as a result of either treating
revenue received by it from the subsidiary as unrelated business taxable income (see §17.68) or ignoring the separate status of the subsidiary and treating all or a part of its activities as being carried on directly by the exempt organization.

Activities of subsidiary. The IRS position is that the activities of a taxable subsidiary are not usually attributed to its exempt parent “unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent, or integral part of the parent.” GCM 39326 (Jan. 17, 1985). According to the IRS, factors to be analyzed include the following (GCM 39598 (Jan. 23, 1987); IRS Letter Ruling 8530132):

- The existence of a bona fide business purpose of the subsidiary;
- The degree to which the subsidiary is managed by an independent board of directors;
- The parent’s involvement in the subsidiary’s daily operation; and
- Whether transactions between the parent and the subsidiary are at arm’s length.

(The IRS has ruled favorably in circumstances in which there could be an overlap of directors and officers. See IRS Letter Rulings 8805059, 8743070.) Such warnings reflect the IRS’s concern that exempt organizations, acting through taxable subsidiaries, might be doing indirectly what they may not do directly.

Author’s perspective. In the author’s opinion, the IRS pronouncements threatening to ignore the separate status of subsidiary organizations are for the most part terrorem statements lacking substance. It has been historically and consistently held that the separate existence of a corporation may not be ignored under the tax laws as long as the corporation has a business purpose or activity and is not acting as an agent for another. See Moline Props. v Commissioner (1943) 319 US 436, 63 S Ct 1132; Britt v U.S. (5th Cir 1970) 431 F2d 227, 234. See also Commissioner v Bollinger (1988) 485 US 340, 108 S Ct 1173. Therefore, even if there are common directors and officers, the IRS cannot legally attribute the activities of a taxable subsidiary to an exempt parent if (a) there is an actual business purpose or activity of the subsidiary, (b) dealings between the parent and the subsidiary are at arm’s length and are properly documented and accounted for, and (c) the activities at issue are carried on by the subsidiary on its own behalf rather than as agent for its parent. The IRS recognizes the great difficulty in ignoring a corporate entity (GCM 39326 (Jan. 17, 1985), quoting GCM 35719 (Mar. 11, 1974)):

To disregard the corporate entity requires a finding that the corporation or transaction involved was a sham or fraud without any valid business purpose, or a finding of a true agency or trust relationship between the entities.

Thus, the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral part of the parent. This is an evidentiary burden that is not easily overcome.

To the author’s knowledge, in only two cases has the IRS successfully denied exemption because of the activities of a for-profit subsidiary, and in the author’s opinion these are anomalies. Orange County Agric. Soc’y, TC Memo 1988–380, aff’d (2d Cir 1990) 893 F2d 529; Greater United Navajo Dev. Enters. (1980) 74 TC 69, aff’d without published opinion (9th Cir 1981) 672 F2d 922. However, the IRS has considered the activities of a for-profit subsidiary in revoking an organization’s §501(c)(3) status. IRS Letter Ruling 200842050.

Although the IRS may not be able to attribute a subsidiary’s activities to an exempt parent under some type of alter ego theory, it may be able to attribute a particular activity to the parent if the subsidiary is
acting as a mere conduit for or agent of the parent. Representatives of the IRS have warned that, if a taxable subsidiary acts as an agent or conduit for an exempt parent, it may deny the exempt status of the latter:

[T]he use of a wholly owned subsidiary of the [exempt] hospital to act as a general partner will not insulate the hospital from the partnership’s activities if the facts establish that the hospital has used its control over the subsidiary to benefit private individuals.

Griffin & Harvey, Service Perspective on the Current Charitable Scene: Service Official “Tells It Like It Is,” 14 NYU Biennial Conf on Tax Planning for Charitable Sector 3–1, at 3–19 (1985). At the same time, the IRS will not ignore the separate existence of a subsidiary that clearly acts independently. For example, the IRS Chief Counsel did not impute the political and legislative activities of a taxable subsidiary operating a newspaper to its exempt parent because the subsidiary was acting independently, not merely as a guise to enable the parent to carry out activities prohibited by IRC §501(c)(3). GCM 33912 (Aug. 15, 1968). See also GCM 39598 (Jan. 23, 1987), as modified by GCM 39646 (June 30, 1987), in which the Chief Counsel refused to recommend revocation of a parent organization’s exempt status as a result of a subsidiary’s nonexempt activities because there was no evidence that the subsidiary was acting as a mere conduit to pass funds from an exempt hospital through the subsidiary to physicians and thereby avoid the inurement prohibition.

§17.73 B. Operating Through Partnerships

Subject to controlled entity rules. Interest, annuities, royalties, and rent paid to an exempt organization by a partnership are subject to the controlled entity rules. See §17.68. Otherwise, an exempt organization’s distributive shares of partnership income, losses, and deductions are treated as though it had earned or incurred them directly. Each such item must be examined separately under the rules in this chapter to ascertain whether the exempt organization would have realized unrelated trade or business income had it carried on the partnership activity that generated the income, loss, or deduction. IRC §512(c). It is apparently the position of the IRS that distributions from a publicly traded partnership will be treated in this manner even though the partnership is taxed as a corporation. Internal Revenue Manual 7.27.6.8 (Feb. 23, 1999). A “publicly traded partnership” is defined in IRC §7704 as a partnership whose interests either are traded on an established securities market or are readily traded on a secondary market. See Buckles, Publicly Traded Partnerships and Unrelated Business Taxable Income, 53 Tax Law 129 (Fall 1999) (criticizing this position).

Types of partnerships not distinguished. No distinction is made between general and limited partnerships under IRC §512(c). Service Bolt & Nut Co. v Commissioner (6th Cir 1983) 724 F2d 519, 523. The court in Service Bolt & Nut rejected the arguments of exempt profit-sharing trusts that had invested as limited partners that their partnership interests should not be characterized as businesses but should be treated as investments because the trusts did not participate in the management of the partnership and their liability was limited to their capital contributions. See also Leila G. Newhall Unitrust (1995) 104 TC 236, aff’d (9th Cir 1997) 105 F3d 482.

Leased property. If a partnership leases property to a tax-exempt entity or has a partner that is a tax-exempt entity, the depreciation deduction claimed by the lessor partnership may be restricted. IRC §168(h).

Organization as partner. The exempt status of an organization participating in a partnership will not be jeopardized if such participation furthers the organization’s exempt purposes and allows the
organization to act exclusively for such purposes and not to benefit nonexempt partners. Plumstead Theatre Soc’y, Inc. (1980) 74 TC 1324, aff’d (9th Cir 1982) 675 F2d 244; GCM 39005 (Dec. 17, 1982). In Rev Rul 98–15, 1998–1 Cum Bull 718, the IRS describes its method of determining whether the criteria of Plumstead have been met. In Housing Pioneers, Inc., TC Memo 1993–120, aff’d (9th Cir 1995) 49 F3d 1395 and Redlands Surgical Servs. (1999) 113 TC 47, aff’d (9th Cir 2001) 242 F3d 904, the courts concluded that the partnerships impermissibly served private purposes. See also St. David’s Health Care Sys. v U.S. (5th Cir 2003) 349 F3d 232, which appears to adopt a requirement that the exempt organization partner must control the partnership to ensure that private purposes are not being inappropriately served. For further discussion, see Griffith, Redefining Joint Venture Control Requirements: St. David’s vs. Goliath?, 37 Exempt Org Tax Rev 255 (Aug. 2002). In Rev Rul 2004–51, 2004–1 Cum Bull 974, the IRS attempted to provide guidance on this issue. This ruling has been criticized in J. Harris, Tax Law Professors Say Recent Joint Venture Ruling Doesn’t Break Ground in Housing, 47 Exempt Org Tax Rev 21 (Jan. 2005).

Transactions with borrowed funds. An exempt organization may have debt-financed income if it purchases an interest in a partnership with borrowed funds or if the partnership invests with borrowed funds. Treas Reg §1.514(c)–1(a)(2), Example 4; Rev Rul 74–197, 1974–1 Cum Bull 143; IRS Letter Ruling 9651001. See §§17.45–17.49. Under some circumstances, taxation of income received from an investment in a limited partnership under the debt-financed income rules due to the partnership borrowing funds can be avoided if the partnership is an offshore entity that elects under United States tax laws to be treated as a corporation and is located in a tax haven that imposes no taxes on the entity. See Daher, Can a “Blocker” Entity Take the “Debt-Financed” Out of Investment Income?, 17 J Tax’n Exempt Orgs 46 (July/Aug. 2005).

Exception to acquisition indebtedness. Acquisition indebtedness does not include indebtedness incurred after October 22, 2004, by a partnership that is a small business investment company licensed after that date, which indebtedness is evidenced by a debenture issued by that company under the Small Business Investment Act of 1958 §303(a) and held or guaranteed by the Small Business Administration. This exclusion, however, does not apply during any period that (IRC §514(c))

- Any exempt organization (other than a governmental unit) owns more than 25 percent of the capital or profit interest in the small business investment company; or
- Exempt organizations (including governmental units other than an agency or instrumentality of the United States) own, in the aggregate, 50 percent or more of the capital or profits interest in that company.

§17.74 C. Limited Liability Companies

A limited liability company with more than one member is classified as either a corporation or a partnership under the income tax laws; if it only has one member, it is classified as either a corporation or as a proprietorship and is regarded as an entity separate from its owner. The classification establishes which unrelated business taxable income rules will apply. Therefore, the rules in §§17.69–17.72 will apply if the LLC is treated as a corporation, those in §17.73 will apply if the LLC is treated as a partnership, and those in §§17.12–17.67 will apply if the LLC is treated as a disregarded entity.
§17.75 VII. INVESTMENTS IN TAX SHELTERS

A tax-exempt organization that participates in certain transactions designated as tax shelters may be required to disclose its participation to the IRS under IRC §6011 or §6033(a)(2), or both. Failure to do so may result in significant penalties. In addition, IRC §4965 imposes excise taxes on tax-exempt organizations described in IRC §501(c)–(d) that are parties to prohibited tax shelter transactions and in some situations imposes excise taxes on managers of such entities who are also parties to prohibited tax shelters. See §17.77.

§17.76 A. Disclosure Under IRC §6011

“Reportable transactions” defined. Under authority granted to it in IRC §6011, the Treasury Department has promulgated regulations requiring persons filing tax returns to file statements with the IRS disclosing participation in certain tax shelters described as “reportable transactions.” The regulations apply to tax-exempt entities as well as taxable entities and individuals. An exempt organization may participate in such transactions to avoid or reduce tax on unrelated business tax income or an excise tax or to enable others to claim tax benefits. The term “reportable transaction” includes (Treas Reg §1.6011–4(b); Prop Reg §1.6011–4(b)(7))

- A “listed transaction,” which is the same or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and has been so identified by notice, regulation, or other IRS published guidance;
- A transaction that has been offered to a taxpayer under conditions of confidentiality and for which a taxpayer has paid an advisor a specified minimum fee;
- A transaction whereby others contract with a taxpayer to refund fees if all or part of the intended tax consequences from the transaction are not realized, or fees to be paid by a taxpayer are contingent on the taxpayer’s realization of tax benefits from the transaction;
- Certain transactions that enable a taxpayer to claim a loss under IRC §165;
- A transaction that is substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other published guidance as a “transaction of interest”; and
- Either (1) a transaction for which a taxpayer, directly or indirectly, pays a fee in any amount to a patent holder or the patent holder’s agent for the legal right to use a tax planning method that the taxpayer knows or has reason to know is the subject of the patent, or (2) a transaction for which a taxpayer as a patent holder or a patent holder’s agent has the right to payment for another person’s use of a tax planning method that is the subject of the patent.

Reporting procedure. Reportable transactions must be reported to the IRS on IRS Form 8886. Normally, Form 8886 must be filed with a regular tax return or any amended return and within the time period allowed for filing those returns.

Penalties. There are significant penalties for failure to timely disclose under §6011. IRC §6707A. The penalty with respect to a listed transaction is $100,000 for an individual and $200,000 in any other situation. The penalty for failure to disclose any other reportable transaction is $10,000 for an individual and $50,000 in any other situation. IRC §6707A(b).
§17.77 B. IRC §4965 Excise Taxes

When imposed. A tax is imposed under IRC §4965 on a tax-exempt entity for any taxable year in which it becomes a party to a prohibited tax shelter transaction and for any subsequent taxable year that it continues to be a party. This tax applies even if the transaction was entered into before May 17, 2006, when §4965 became effective. A tax is also imposed on a tax-exempt entity in any taxable year that it is a party to a subsequently listed transaction. IRC §4965(a)(1)(B). This tax applies whether or not the tax-exempt entity knew or had reason to know that it was a party to a prohibited transaction.

“Prohibited tax shelter transactions” include listed transactions, confidential transactions, and transactions with contractual protection that are reportable transactions described in §17.76. IRC §§4965(e)(1), 6707A(e). A “subsequently listed” transaction is one that the IRS published as a listed transaction after a tax-exempt entity became a party to the transaction, if the transaction was not a prohibited reportable transaction when the entity became a party. IRC §4965(e)(2).

Calculating tax. Generally, the tax on a tax-exempt entity for a particular year is the amount obtained by multiplying the highest corporate tax rate by the greater of (IRC §4965(b)(1)(A))

- The entity’s net income from the transaction for that year, or
- 75 percent of the proceeds received from the transaction by the tax-exempt entity for that year.

However, if the tax-exempt entity knew or had reason to know that it was entering into a prohibited transaction, the penalty will be the greater of 100 percent of the entity’s net income from the prohibited transaction, or 75 percent of the proceeds from the prohibited transaction. Net income will be adjusted with respect to a subsequently listed transaction. IRC §4965(b)(1)(B). For this purpose, “any amount that is a gift or a contribution to a tax-exempt entity and is attributable to a prohibited tax shelter transaction will be treated as proceeds … unreduced by any associated expenses.” Treas Reg §53.4965–8(b)(2)(ii).

Tax imposed on managers who approve transaction. An excise tax of $20,000 is imposed on any manager of a tax-exempt entity who approves of the entity’s participation in a prohibited tax shelter transaction if the manager knew or had reason to know that it was a tax shelter transaction. IRC §4965(a)(2), (b)(2). The tax applies separately to each approval or other act causing the participation. A “manager” is a person with authority similar to that exercised by an officer or director and with authority to approve a transaction or cause the entity to be a party to a transaction. IRC §4965(d).

A tax-exempt entity or a manager that is liable for §4965 tax must report the tax liability on IRS Form 4720.


§17.78 C. Disclosure Under IRC §6033(a)(2)

A tax-exempt entity must disclose to the IRS that it is a party to a prohibited tax shelter transaction subject to tax under IRC §4965, and must provide the identities of other participating parties known to the tax-exempt entity. IRC §6033(a)(2); Treas Reg §1.6033–5. The required disclosure is made on IRS Form 8886-T. The penalty for each failure to disclose is $100 per day, not to exceed $50,000 with respect to any one disclosure. IRC §6652(c)(3). If a pay entity or manager of a tax exempt entity fails to make the required disclosures after a demand by the IRS, an additional penalty of $100 applies per day, up to $10,000 for any one disclosure. IRC §6652(c)(3)(B)(ii).