
Nonprofit Law Resource Library

Taxation of Unrelated Business Income

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1. Introduction

A unifying theme underlies the laws regarding unrelated business income taxation. Simply stated, income derived from activities unrelated to a tax-exempt organization's purposes is taxed as if earned by a comparable for-profit entity. Generally, such income is subject to tax at the regular corporate rates. In computing unrelated business income taxes, most recognized business deductions are available to exempt organizations.

The unrelated business income tax was enacted in 1950. Prior to that time, exempt organizations could own and operate unrelated businesses on a tax-free basis. Thus, as a subsidiary of the New York University School of Law, the Mueller Macaroni Company paid no income taxes. *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (1951).

The statutory changes of 1950, and subsequent revisions in the Tax Reform Act of 1969, were intended to prevent unfair competition between exempt and taxable organizations. Internal Revenue Code ("IRC" or the "the Code") § 513(a). The laws apply to nearly all tax-exempt organizations, including IRC § 501(c)(3) organizations (private foundations and public charities) as well as religious, social welfare, business, labor, and fraternal organizations.

If unrelated business income comprises a "substantial" portion of an exempt organization's income, loss of tax-exempt status may result. *Indiana Retail Hardware Association v. U.S.*, 366 F.2d 998 (Ct. Cls. 1966). There is no fixed percentage or mechanical test for determining what constitutes a substantial portion. On the one hand, the IRS has defined the term substantial in relation to the legislative activities of exempt organization to be 5% or greater. Treasury Regulations (hereinafter "Regs.") 1.501(c)(3)-1(b)(3)(i). On the other hand, the IRS did not revoke an organization's tax exemption even though 75% of its income was derived from unrelated sources. *Rev. Rul. 57-313*, 1957-1 C.B. 316.

In the absence of a definitive threshold level, practitioners may wish to follow a 20% guideline. If an organization's unrelated business income exceeds 20% of gross income, then the legal risks and options available to the organization should be carefully evaluated and monitored. Once an organization's unrelated business income exceeds 50%, it may be difficult to continue to demonstrate to the IRS that the organization primarily furthers

exempt purposes. In either instance, the organization may wish to establish a for-profit subsidiary, as discussed below in Part III, Section C, or other related organization.

2. Unrelated Business Income

Unrelated business income is defined as income derived from 1) a trade or business, 2) which is regularly carried on, and 3) which is not substantially related to the performance of tax-exempt functions, i.e., it does not contribute importantly to the achievement of tax-exempt purposes. The fact that income was produced for use in furthering exempt purposes does not qualify the income as related; the income itself must be derived in the course of furthering an exempt purpose. IRC § 513(a). For unrelated business income taxes to be incurred, all three elements must be present.

a. Trade or Business

A trade or business, as defined by the Code, is widely encompassing. It includes any activity carried on for the production of income from the sale of goods or the performance of services. Regs. § 1.513-1(b). Characterization as a trade or business depends on the level of active participation by the exempt in generating revenue.

Thus, an important exclusion from unrelated income is revenue generated in a passive manner. The major recognized forms of passive income are interest earnings, dividends, royalty payments, rents from real property, and revenues from the sale of property. IRC § 512(b)(1)-(3), discussed below in Part III, Section A. Although there is no specific exclusion for fundraising, most types of fundraising are presently considered by the IRS to be administrative or management functions, as opposed to active business operations (see below in Part IV, Section A).

b. Regularly Carried On

Business activities of exempt organizations will be deemed to be regularly carried on "if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations". Reg. § 1.513-1(c)(1). Phrased another way, when activities are "systematically and consistently promoted and carried on by the organization, they meet the requirement of regularity". Ibid.

- Isolated Sales

Although there is no accepted threshold measure of frequency and continuity, case rulings provide some guidance for deciding whether an activity is regularly carried on. It is clear that the one-time sale of billing programs developed by an exempt health care provider is not an activity regularly carried on. IRS Private Letter Ruling 7905129. Thus, even though the income derived from the sale was not related to an exempt purpose, no tax was incurred because the sale was not a frequent or continuing activity.

- Special Events and Benefit
- Advertising (Playbills)

Even activities conducted intermittently or sporadically throughout the year may not be treated as regularly carried on. For instance, an occasional dance, to which the public is invited for a fee, would not normally constitute the regular carrying of a trade or business. Reg. § 1.513-1(c)(2)(iii). Similarly, a hospital auxiliary's operation of a food stand for two weeks at a state fair is not considered regularly carried on (IRS Publication 598), nor is the publication of advertising in the program of a cultural performance or sport event (Reg. § 1.513-1(c)(2)(ii). Moreover, such activities will not be regarded as regularly carried on merely because they recur annually.

However, in determining whether such sporadically conducted activities are regularly carried on, attention must be paid to comparable commercial activities of taxable organizations. For instance, the distribution of Christmas cards by an exempt organization was treated as an unrelated business, even though conducted just once per year, because the IRS measured frequency in terms of comparable commercial Christmas card sellers. IRS Private Letter Ruling 8203134.

- Advertising (Yearbooks)

Additionally, the sale of advertising in a book published only once per year may be deemed to be an activity regularly carried on. The IRS ruled that since an exempt organization contracted with a commercial firm for the solicitation of advertising sales on a year round basis, the frequency of actual publication was not determinative. IRS Revenue Ruling (hereinafter "Rev. Rul.") 73-424, 1973-2 Cumulative Bulletin ("C.B.") 190.

c. Substantially Related

General Application

Income derived by an exempt organization is not taxed if the income-generating activity contributes importantly to the tax exempt purposes of the organization. IRC § 513(a); Rev. Rul. 75-472, 1975-2 C.B. 208.

- Health Clubs

Therefore, the operation of a health club by a public charity organized to provide physical fitness for young people was deemed to be an unrelated business. The IRS determined that high membership fees discouraged young people from joining the health club. Rev. Rul. 79-360, 1979-2 C.B. 236. However, the profits derived by a similar exempt organization's health club, which was specifically geared to serving individuals within the community, was treated as related income. IRS Technical Advice Memorandum 8505002.

- Merchandise Sales

Certain activities which even indirectly further exempt purposes may satisfy the "important contribution" requirement. Merchandise sales (stationary, clothing,

and accessories) by a conservation organization are related activities because the products, containing the logo of the organization or other environmental reference, stimulate interest in wildlife preservation. IRS Private Letter Ruling 8107006.

- Illustrative Related Activities

Likewise, related activities include the operation of a lawyer referral service by a bar association (IRS Private Letter Ruling 8417003), the provision of group insurance for member agencies by a social welfare organization (IRS Private Letter Ruling 8442092), the sale of educational products (IRS Private Letter Ruling 8518090), and the sale of software (IRS Private Letter Ruling 8512084).

- Illustrative Unrelated Activities

In contrast, activities that were ruled not to contribute importantly to exempt purposes include the provision of veterinary services for a fee by an animal cruelty prevention society (IRS Private Letter Ruling 8303001), the sale of uniforms by a labor union (IRS Technical Advice Memorandum 8437014), the provision of language translation services by an international trade promotion association (Rev. Rul. 81-75, 1981-1 C.B. 356), the management of health plans by a business league (Rev. Rul. 66-151, 1966-1 C.B. 152), and liquor sales by a veterans organization (IRS Private Letter Ruling 8530043).

- Travel Tours

For the practitioner, drawing a clear line between related and unrelated activities can be a challenging task. For instance, a variety of exempt organizations, such as educational, scientific, and conservation organizations regularly sponsor tours for their members. On the one hand, it is clear that travel tours structured primarily as formal educational programs are related activities. Rev. Rul. 70-534, 1970-2 C.B. 113. On the other hand, travel tours that are merely recreational in nature containing no educational components are unrelated activities. Rev. Rul. 78-43, 1978-1 C.B. 164. For the majority of tours that fall somewhere in between, it may be difficult to ascertain in advance, without the benefit of a private letter ruling, whether a particular tour contains sufficient lecture or class time to constitute related activity.

- Hospitals (Diagnostic Services)

Problems may also arise when dealing with organizations undergoing a change or expansion of services. For example, many hospitals are currently re-defining and broadening their purposes in light of changing medical practices and needs. This has led to confusion on the part of the IRS and the courts in attempting to determine which specific activities are related to a hospital's purposes.

Thus, the Tax Court has held that fees derived from diagnostic procedures performed on private patients of hospital physicians are related to a hospital's

exempt purposes. *St. Luke's Hospital of Kansas City v. United States*, 494 F. Supp. 85 (W.D. Mo., 1980). However, the IRS has stated that it would not follow the court in this instance because it disagrees with the characterization of staff physicians as members of the hospital. The IRS therefore determined in two separate revenue rulings that similarly-derived laboratory fees constituted unrelated business income. Rev. Rul. 85-109, 1985-2 C.B. 165 and Rev. Rul. 85-110, 1985-2 C.B. 166. It has been argued that drawing such a distinction between in-patient and out-patient care represents an outmoded approach to modern medical practice.

- Bar Associations

Even slight variations in an organization's own description of its income may lead to contrary results. A bar association sold standard legal forms at a profit to its members. The income was determined to be unrelated to the protection and advancement of the professional interests of members of the bar. Rev. Rul. 78-51, 1978-1 C.B. 165.

However, another bar association impressed upon the U.S. Tax Court that its continual monitoring and updating of legal forms kept attorneys current with state law, thus advancing their knowledge and competency. The court held that the standard legal forms were related to the association's exempt purposes, and ordered a refund of unrelated business income taxes paid. *San Antonio Bar Association v. United States*, 80-2 U.S.T.C. 9594 (W.D. Tex. 1980).

- Museum Shops

For the practitioner, therefore, emphasis must be placed on the extent to which the result in any individual case may be dependent on slight changes in the facts and circumstances presented. For instance, the sale of reproductions of art work by an art museum is a related trade or business. Rev. Rul. 73-104, 1973-1 C.B. 263. However, the sale of scientific books by a museum of folk art constitutes an unrelated trade or business even though other items sold in the museum shop relate to the organization's exempt function. Rev. Rul. 73-105, 1973-1 C.B. 263.

Fragmentation

The latter case illustrates the rule of "fragmentation". For purposes of calculating gross unrelated income, the IRS fragments a tax-exempt organization's operation, run as an integrated whole, into component parts. The Code states, "an activity does not lose identity as a trade or business merely because it carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization". IRC § 513(c).

- Retail Sales (Vocational and Educational Organizations)

Therefore, while the sale by an exempt vocational school of articles made by its students is a related business, the sale of articles made by nonstudents is not. Rev. Rul. 68-581, 1968-2 C.B. 250. Likewise, the sale by a university bookstore of books, supplies, and accessories is regarded as related activity, while the sale of items such as clothing and plants constitutes taxable activity. IRS Private Letter Ruling 8025222. In their bookkeeping practices, therefore, exempt organizations must record and account for each item of sale separately.

- Advertising (Medical Journals)

In perhaps the most widely cited application of the fragmentation rule, the sale of a monthly journal by medical organizations is considered to be related activity, but the sale of advertising within such periodicals is unrelated. The Supreme Court has held that such advertising is taxable even though it may have been educational or informational. *American College of Physicians v. United States*, 106 S.Ct. 1591 (1986), 86-1 U.S.T.C. 9339. For such advertising to be considered related activity, it must contribute to the accomplishment of an exempt purpose, as in the case of a university newspaper the purpose of which is to train students in journalism. Reg. § 1.513-1.

- Hospitals (Sale of Pharmaceuticals)

Similarly, the sale of pharmaceuticals by the pharmacy of an exempt hospital to patients of the hospital is related activity, though sale to the general public generates unrelated business income. *Hi-Plains Hospital v. United States*, 670 F.2d 528 (5th Cir. 1982), 82-1 U.S.T.C. 9259; Rev. Rul. 68-375, 1968-2 C.B. 245

3. Exclusions From Unrelated Business Income

a. Passive Income

Passive income, including interest, dividends, rents from real property, revenue from property sales, and royalty payments, is generally excluded from unrelated business income. IRC §§ 512(b)(1) - (5); Reg. §§ 1.512(b)-1(a) - (d). If passive income is generated through controlled subsidiaries or through the use of borrowed funds, this exclusion does not apply. See Part IV, Section B, below.

1. Interest and Dividends

Most interest and dividends, including annuities and payments relating to loaned securities, are excluded from unrelated business income. IRC § 512(b)(1). Note however, that partnership income, including income derived by passive investors (i.e., limited partners), is treated as unrelated business income. Reg. § 1.512(c)-1; *Service Bolt & Nut Company Profit Sharing Trust v. Commissioner*, 724 F.2d 519 (6th Cir. 1983).

2. Rent From Real Property

Income derived from the rental of real property is usually excluded from taxation. However, income derived from the rent of personal property is not excludable. In the case of a lease containing both real and personal property, if more than 50% of the rent is derived from personal property then none of the rental income is excludable. IRC § 512(b)(3).

Furthermore, if the amount of rental income is dependent on a percentage of the lessee's sales or profits, the rental income will not qualify for exclusion. The Treasury Regulations reason that such division of profits connects the exempt organization with the active conduct of a business. Therefore, the rental payments can not be considered passive. Regs. § 1.512(b)-1(c)(2)(iii).

- Landlord Maintenance and Cleaning Services

Rental income may also be taxable if the lease involves the performance of services beyond those normally provided by a landlord. For instance, normal maintenance and repairs may be provided by the exempt organization/lessor. If additional cleaning, laundry, or other personal services are provided, the rental income will be construed as derived from a trade or business. Reg. § 1.512(b)-1.

3. The Sale of Property

Gains or losses from the sale or other disposition of property are generally not taxed as unrelated income. IRC § 512(b)(5)(B). Under this provision, all income that would normally be considered capital gain income is excluded from taxation. Significantly, however, this exclusion does not apply to inventory or property otherwise held primarily for sale to customers in the ordinary course of business. Reg. § 1.512(b)-1(d).

4. Royalties

Royalty income is excluded from taxation. IRC § 512(b)(2). Excludable royalties include payments from the licensing of patents (Rev. Rul. 73-193, 1973-1 C.B. 262), trademarks (Rev. Rul. 81-178, 1981-2 C.B. 135), and mineral rights (Reg. § 1.512(b)-1). In contrast to the rules regarding rental payments, receipts may still be considered royalty income when the payment is based on gross profits. In particular, revenues derived from a share of the gross profits of a gas producing property were ruled to be royalty payments. (IRS Private Letter Ruling 7741004).

In order to avoid unrelated business income taxes, some exempt organizations have attempted to classify, as royalties, payments that are in fact fees for services. The IRS, however, ignores contractual nomenclature and looks to the true nature of such transactions.

- Personal Service, Membership, List, and License Agreement "Royalties"

For example, royalties were ruled not to include payments for personal appearances (Rev. Rul. 81-178, 1981-2 C.B. 135) or receipts from the rental of donor lists (*Disabled American Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981)). Additionally, if the exempt organization maintains control over or liability for the commercial enterprise, the royalty exclusion will likely be denied. Thus, payments derived from a license of property under which an exempt organization was liable for some development and operational costs were treated as unrelated income. (Rev. Rul. 69-179, 1969-1 C.B. 158).

- **Book Royalties**

In some cases, however, a venture that would otherwise produce taxable proceeds can be legitimately structured as a royalty arrangement. For instance, the direct publication and sale of an unrelated book by an exempt organization would normally generate unrelated business income. However, if the book were published and sold by a commercial publisher, and the organization were to retain only a true royalty interest, no unrelated business income would result. Rev. Rul. 69-430, 1969-1 C.B. 129.

b. Research Activities

There are three primary exclusions available for scientific research activities. First, income is not unrelated if "derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof." IRC § 512(b)(7). Second, income derived for research by colleges, universities, and hospitals is excluded. IRC 512(b)(8). Third, income derived by exempt organizations which operate primarily for scientific research purposes and make the research results available to the public free of charge is untaxed. IRC § 512(b)(9).

The term "research" is not clearly defined. It does include the testing of pharmaceuticals for the development of new products. IRS Private Letter Ruling 7936006. However, research does not include activities that are incidental to ordinary business operations, such as the testing or inspection of products or materials. *Midwest Research v. Commissioner*, 744 F.2d 635 (8th Cir. 1984).

c. Volunteer Activities.

- **Clothing Stores**

Activities that would otherwise be unrelated are deemed to be related if "substantially all the work in carrying on such trade or business is performed for the organization without compensation". IRC § 513(a)(1). An example is a second-hand clothing store operated by an orphanage in which substantially all of the work in running the store is performed by volunteers. S. Rep. No. 2375, 81st Cong., 2d Sess. (1950) at 108. In a U.S. Tax Court case, it was held that a religious order's farming income was not taxable

because the farm was maintained by unpaid members of the order. *St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner*, 85 T.C. 9 (1985).

- Museum Shops

Two cases provide some guidance in applying the term "substantially" in this context. In one instance, two full-time employees and 15 volunteers of an art museum sold and rented works of art. The IRS ruled that substantially all the work was not performed by volunteers. Private Letter Ruling 8040014. However, a similar program operated by volunteers 95% of the total time was deemed to be substantially operated by volunteers. Private Letter Ruling 8040014.

- d. Sales of Contributed Property (the Thrift Shop Exception).

"The selling of merchandise, substantially all of which has been received by the organization as gifts or contributions" is not an unrelated trade or business. IRC § 513(a)(3). This exception is most commonly used by thrift shops which sell donated clothes and other items to the general public. Rev. Rul. 71-581, 1971-2 C.B. 165.

- e. Activities for Convenience of Members, Employees et al.

- Restaurants, Gift Shops, Parking Lots, Laundries

A trade or business carried on by an exempt organization "primarily for the convenience of its members, students, patients, officers or employees" is not taxable. IRC § 513(a)(2). Thus, the operation by an art museum of a cafeteria and snack bar for use by its staff and visiting members of the public is considered a related activity (Rev. Rul. 74-399, 1974-2 C.B. 172), as is the operation of gift shop (Rev. Rul. 69-267, 1969-1 C.B. 160), and parking lot (Rev. Rul. 69-269, 1969-1 C.B. 160) for the staff, patients, and visitors of a hospital.

The operation of a laundry by a college for its students qualifies under this exclusion, but if operated primarily for the benefit of the public it is an unrelated business. S. Rep. No. 2375, 81st Cong., 2d Sess. (1950) at 108. Similarly, the operation of dining facilities for the general public by a veteran's organization is an unrelated trade or business. Rev. Rul. 68-46, 1968-1 C.B. 260.

- f. Trade Shows

Under provisions of the Tax Reform Act of 1976, the term unrelated trade or business does not include certain convention and trade show activities. IRC § 513(d)(1). The income that is excluded from taxation is that derived by exempt organizations from the rental of display space to exhibitors. Such activity is

excluded for most exempt organizations (including charitable, social welfare, and trade organizations), if the promotion of the products and services, or the education of those in attendance, advances the exempt purposes of the organization. IRC § 513 (d)(3)(B). Note that should these requirements not be met, such income might also be excludable if the sponsoring of trade shows were not an activity regularly carried on by the sponsoring organization.

g. Bingo Games and Charitable Gambling

The Revenue Act of 1978 specifically excludes most forms of bingo games from unrelated business income tax. IRC § 513(f)(2)(A). The Tax Reform Act of 1984 also excludes any income derived from the conduct of games of chance which, under state law, can only be conducted by nonprofit organizations.

h. Membership and Mailing Lists

The sale or exchange by 501(c)(3) organizations to other 501(c)(3) organizations of their membership or mailing lists is specifically excluded from taxation. IRC § 513(h)(1)(B). This exception does not apply to sales to other exempt organizations or non-exempt businesses. However, in one case the IRS ruled that the sale of a membership directory by an exempt 501(c)(6) business league to its members furthered the purposes of the league and was thus deemed related activity. Rev. Rul. 75-201, 1975-1 C.B. 164.

i. Low Cost Items

Income derived from the sale of low cost articles such as T-shirts and coffee mugs, by 501(c)(3) organizations only, are excluded from taxation if their distribution is "incidental to the solicitation of charitable contributions". IRC § 513(h)(1)(A). In order for this exception to apply, the recipient must be able to retain the item regardless of whether a contribution is made.

A low cost item is defined as any article costing the exempt organization (not the recipient) no more than \$5, based on 1987 dollars and adjusted for inflation annually. If more than one item is distributed to a single recipient in a calendar year, then the aggregate of the items is treated as one article.

j. First \$1,000 of Net Income

There is a specific deduction for the first \$1,000 of net unrelated business income. IRC § 512(b)(12).

4. Special Applications of the unrelated business income rules

a. Fundraising.

Income derived from fundraising activities traditionally has not been taxed as unrelated business income. Technically, however, much fundraising activity would appear to display

the requisite elements of unrelated activity. First, fundraisers, whether on staff or independent, render services that would seem to qualify as the active conduct of a business. Second, in many, if not most organizations, fundraising is a frequent and continuous effort which would therefore be considered regularly carried on. Third, funds so raised are not derived in a manner which normally contributes importantly to the achievement of tax-exempt functions.

To date, the IRS has generally resisted the temptation to treat fundraising proceeds as unrelated income. The IRS may perceive fundraising to be more of an administrative or management activity than a business enterprise. Inasmuch as funds are donated without the traditional indicia of consideration present in most commercial transactions, the act of soliciting funds may not be seen as a business activity. In any case, the conduct of fundraising is not the type of "unfair competition" between tax-exempt and taxable entities contemplated by Congress

Nevertheless, the IRS may use the weaknesses of these arguments to become more involved in regulating charitable fundraising. Indeed, the IRS has indicated concern about the use of affinity credit cards and other forms of cause-related marketing, certain planned giving techniques, and the sale of items for "suggested minimum contributions". See *The Hope School v. United States*, 612 F.2d 298 (7th Cir. 1980); *Disabled American Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981); *Christian Stewardship Assistance, Inc. v. Commissioner*, 70 T.C. 1037 (1978); IRS Private Letter Rulings 8203134 and 8233011. Therefore, in advising clients as to the legal implications of innovative fundraising practices, the practitioner should be attuned to unrelated business income issues that may arise unexpectedly.

b. Unrelated Debt-Financed Income

1. Debt-Financed Property

As discussed above in Part III, Section A, unrelated passive income (e.g., interest, dividends, rent, royalties, etc.) is generally excluded from taxation. This is not the case, however, when such income is derived through the use of borrowed funds. IRC § 514(b). If, for example, an exempt organization purchases securities with borrowed funds, the dividends will be subject to tax.

Prior to the Tax Reform Act of 1969, it was possible for a tax-exempt organization to purchase a business through a loan from the business itself. The loan could be repaid from the newly tax-exempt earnings of the business, thus giving the exempt organization a significant advantage over for-profit competitors.

- Purchase of Businesses

Through such devices, a tax-exempt organization purchased a \$1.3 million business without the investment of any of its own funds while at the same time the former owners increased their own net income. *Commissioner v. Clay Brown*, 380 U.S. 563 (1965). In other scenarios described in the Treasury Regulations, the use of

stock re-purchases and the leasing of assets back to the business owners enable original shareholders to derive considerable tax-free income. Reg. § 1.514(b)-1.

Under the Tax Reform Act of 1969, any income derived through the use of borrowed funds is taxable as unrelated business income. It is important, however, to keep in mind that the use of debt-financed property for purposes related to exempt functions does not cause tax liability. It is only unrelated debt-financed property that does not qualify for the passive income exception. IRC § 514(b)(1)(A)(i).

- Arts Organizations (Capital Improvements)

For instance, suppose an exempt performing arts center borrows funds to purchase and renovate a theater. Since the organization presumably plans to utilize the theater in the conduct of exempt cultural purposes, no tax would be incurred on income subsequently generated from theater operations.

Suppose, though, the exempt organization also purchases office space adjoining the theater and leases the space to commercial tenants. A proportional allocation of indebtedness would then have to be made. The leased portion of the property would be treated as unrelated debt-financed property and the income generated by it taxed accordingly.

2. Acquisition Indebtedness

The basis for determining tax liability for debt-financed property is by calculating an organization's "acquisition indebtedness". Essentially, acquisition indebtedness is the amount of debt in proportion to the entire cost of the property. For example, assume in the above illustration that the exempt organization financed the office space through a \$750,000 mortgage and \$250,000 down payment. In that case, 75% of the income generated would be taxable. 75% of the costs would also be deductible. Note that depreciation, for purposes of calculating acquisition indebtedness, may only be computed on the straight-line method. IRC § 514(a)(3).

Acquisition indebtedness includes not only the actual debt incurred in acquiring or improving the property, but also debt incurred:

- before the transaction if such indebtedness would not have been incurred but for such acquisition or improvement, and;
- after the transaction if the indebtedness would not have been incurred but for such acquisition or improvement, and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement. IRC § 514(c)(1).

Thus, in the above example, feasibility studies conducted prior to the purchase and promotional activities performed subsequent to the renovation, if paid for with borrowed funds, would be included in calculating acquisition indebtedness.

3. Sale of Debt-Financed Property

In the event that debt-financed property is sold, the acquisition indebtedness is deemed to be the highest amount of indebtedness during the twelve-month period preceding the date of sale. IRC § 514(c)(7). This provision was enacted to prevent an organization from re-paying its debt in contemplation of a large gain from the sale of the property.

If the organization is able to pay off the debt more than twelve months before the sale, it can avoid taxes from any gain on the sale. If paid within the twelve-month period or after the sale, then the gain on the acquisition indebtedness is taxable as capital gain.

4. Exceptions to the Debt-Financed Property Rules

- Neighborhood Land.

The tax on unrelated debt-financed property does not apply to income from real property first, if the land is located in the neighborhood of other property used by the organization in furthering exempt purposes and, second, if the organization plans to use the property for exempt purposes within ten years. IRC § 514 (b)(3).

- Real Estate Owned by "Qualified Organizations"

Educational institutions, employee benefit trusts, and certain title-holding organizations, deemed by the Code to be qualifying organizations are exempt from the debt-financed property rules. IRC § 514(c)(9).

- Research Activities

Research activities of the kind excluded from unrelated business income (as described above in Part III, Section B) continue to be excluded even if funded with debt. IRC § 514(b)(1)(c), referencing IRC §§ 512(b)(7) - (9).

c. Subsidiaries

As previously stated, if unrelated business income comprises a "substantial" portion of an exempt organization's income, the organization risks losing tax-exempt status. In such circumstances, the exempt organization may wish to establish a taxable subsidiary. The subsidiary may freely engage in commercial activity without fear of loss of exemption to the parent.

As discussed above, most forms of passive income are excludable from taxation. However, in regard to payments to exempt parents from controlled subsidiaries (defined below), only dividend payments continue to be treated as passive, non-taxable income.

Other types of passive income accruing to the parent are taxable. The reason for the treatment of passive income in this manner is that both tax-exempt parents and their for-profit subsidiaries would otherwise be able to circumvent paying income taxes on unrelated income.

For instance, assume an exempt organization derives a substantial portion of its income from an unrelated business. In attempting to protect its tax-exempt status, the parent establishes a wholly-controlled for-profit subsidiary. The parent enters a lease with the subsidiary for a fixed rental amount nearly equal to 100% of its after expense net income. By deducting rental payments to the parent from gross income, the subsidiary would incur almost no tax liability. Prior to 1969, the parent would have incurred no tax in receiving rental income from its subsidiary. Additionally, the exempt parent, through the simple device of creating a subsidiary, would have defeated the restraints imposed on exempt organizations against deriving substantial unrelated income.

Therefore the present Code specifically includes rents, interest, and most other forms of passive income derived from a controlled taxable subsidiary as taxable unrelated income. IRC § 512(b)(13). Dividends continue to be excluded from taxation because the subsidiary normally pays taxes on earnings before distributing dividends to the exempt parent.

A controlled organization is defined by the IRS as one which is controlled to the extent of 80% or more by another organization. The 80% control level is established either through stock ownership or by interlocking boards of directors. IRC § 368(c). Note that under special rules applicable to private foundations, ownership of more than 20% of the stock of any corporation is prohibited. IRC § 4943.

5. Computation and payment of unrelated business income taxes

Unrelated business taxable income is the gross income derived from an unrelated trade or business less deductions which are directly connected to the carrying on of such trade or business. IRC § 512(a)(1). Generally, gross income and the corresponding deductions are computed the same way in which corporate income taxes are calculated. See IRC §§ 162, 167.

Unrelated taxable income is usually subject to the regular corporate income tax rates. Exempt trusts are taxable at trust rates. Reg. § 1.511-1. Returns are made on Form 990-T, a copy of which is attached in the Appendix. Form 990-T, along with Form-990, is due four months and 15 days after the close of the fiscal year.

Exempt organizations must also make quarterly estimated tax payments under the same rules applicable to corporate income. IRC § 6154(h); Reg. § 1.6302-IT. The various Code provisions relating generally to penalties for late filings and the under-payment of taxes also apply to unrelated business income.

When an exempt organization derives income from two or more unrelated activities, unrelated taxable income is the aggregate of all unrelated income minus the aggregate of all allowable deductions. Reg. 1.512(a)-1(a).

- Unrelated Staff Time

Where staff time is used to conduct both exempt and unrelated activities, deductions must be allocated between the uses on a reasonable basis. Reg. 1.512(a)-1(c). Thus, for example, if an employee earns \$50,000 and devotes 10% of her time to unrelated activity, then \$5,000 of her salary is deductible from gross unrelated taxable income.

- Dual Use of Facilities
- University Properties

In circumstances involving the dual use of facilities, a similar principle applies. For instance, in *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1958 (2d Cir. 1984), a university field house was used for both exempt and unrelated purposes. The university sought to allocate fixed operational expenses for the field house on the basis of its actual use. In other words, a deduction was taken based on a proportional allocation of the time the facility was actually used for exempt and unrelated purposes. The IRS contended that a deduction could be taken only for the amount of time used for unrelated purposes in relation to total available use, i.e., the total number of hours in the tax year. The courts found for the university.

- Advertising (Computation of Unrelated Gain and Loss)

In situations where there is a gain or loss from an exempt activity that is connected to a gain or loss from an unrelated activity, the calculation becomes more complicated and a special rule applies. Reg. § 1.512(a)-1(f). Assume there is exempt gain, after expenses, from the sale of a tax-exempt organization's periodical. There is also taxable gain from the unrelated sale of advertising in the periodical. In this instance, the tax payable would be the gross advertising income less the advertising costs. For instance, if advertising income were \$40,000 and advertising costs were \$30,000, unrelated taxable income would be \$10,000.

Suppose, however, there were a loss from the exempt-purpose sale of the periodical. In that case, the organization would be permitted to deduct the total costs (both related and unrelated) from the total income attributable to the periodical.

For instance, if the exempt sale income were \$50,000 and expenses were \$80,000, there would be a net loss of \$30,000. In that case, the \$30,000 net loss from the exempt sales operations could be deducted from the \$10,000 unrelated income gain, thereby leaving no unrelated business income attributable to the advertising, and a combined \$20,000 loss attributable to the periodical.

In regard to the combined \$20,000 loss, note that the Treasury Regulations allows such aggregation only for the purpose of offsetting advertising income from the periodical. The \$20,000 aggregate loss in this instance may not be carried over to any other unrelated taxable gain derived by the organization.

Appendices

1. Instructions for IRS Form 990-T, Exempt Organization Business Income Tax Return.
2. IRS Form 990-T, Exempt Organization Business Income Tax Return.
3. IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations.
4. 1990 IRS Letter Rulings Regarding Unrelated Business Income.