

# Publication 598

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## Tax on Unrelated Business Income of Exempt Organizations

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

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

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

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

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

1. In conjunction with an international, national, state, regional, or local fair or exposition;
2. In accordance with state law that permits the activity to be operated or conducted solely by such an organization or by an agency, instrumentality, or political subdivision of the state; or

3. In accordance with state law that permits an organization to be granted a license to conduct an activity for not more than 20 days on paying the state a lower percentage of the revenue from the activity than the state charges nonqualifying organizations that hold similar activities.

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

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

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

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

Providing facilities, services, or other privileges (for example, complimentary tickets, pro-am playing spots in golf

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

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

If part of a payment would be a qualified sponsorship payment if paid separately, that

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

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

Advertising includes:

1. Messages containing qualitative or comparative language, price information, or other indications of savings or value;



2. Endorsements; and
3. Inducements to purchase, sell, or use the products or services.

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

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

place or being broadcast doesn't, by itself, affect whether a payment qualifies.

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

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

the organization (for example, a program or brochure distributed at a sponsored event).

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

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

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

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

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

## **4.**

# **Unrelated Business Taxable Income**

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

See Regulations section 1.512(a)-6 for more information.

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

## **Income**

Generally, unrelated business income is taxable, but there are exclusions and special

rules that must be considered when figuring the income.

## **Exclusions**

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

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

***Exception for insurance activity income of a controlled foreign corporation.*** This exclusion doesn't apply to income from certain insurance activities of an exempt organization's controlled foreign corporation.

The income isn't excludable dividend income, but instead is UBTI to the extent it would be so treated if the exempt organization had earned it directly. Certain exceptions to this rule apply. For more information, see section 512(b)(17).

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

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

1. Provides for the return to the exempt organization of securities identical to the securities loaned,



2. Requires payments to the organization of amounts equivalent to all interest, dividends, and other distributions that the owner of the securities is entitled to receive during the period of the loan,
3. Doesn't reduce the organization's risk of loss or opportunity for gain on the securities,
4. Contains reasonable procedures to implement the obligation of the borrower to furnish collateral to the organization with a fair market value each business day during the period of the loan in an amount not less than the fair market value of the securities at the close of the preceding business day, and
5. Permits the organization to terminate the loan upon notice of not more than 5 business days.

Payments with respect to securities loans include:

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

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

**Royalties.** Royalties, including overriding royalties, are excluded in computing UBTI.

To be considered a royalty, a payment must relate to the use of a valuable right.

Payments for trademarks, trade names, or copyrights are ordinarily considered royalties.

Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily considered royalties. However, royalties don't include payments for personal services.

Therefore, payments for personal appearances and interviews aren't excluded as royalties and must be included in figuring UBTI.

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

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

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

or to royalties received from a controlled corporation (discussed under *Income From Controlled Organizations*, later).

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

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

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

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

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

1. The rent attributable to all the leased personal property increases by 100% or more because additional or

substitute personal property is placed in service, or

2. The lease is modified to change the rent charged (whether or not the amount of rented personal property changes).

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

***Exception for rents based on net profit.***

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

***Exception for income from personal services.*** Payment for occupying space when personal services are also rendered to the occupant doesn't constitute rent from real

property. Therefore, the exclusion doesn't apply to transactions such as renting hotel rooms, rooms in boarding houses or tourist homes, and space in parking lots or warehouses.

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

**Income from research.** A tax-exempt organization may exclude income from research grants or contracts from UBTI. However, the extent of the exclusion depends



on the nature of the organization and the type of research.

Income from research for the United States, any of its agencies or instrumentalities, or a state or any of its political subdivisions is excluded when computing UBTI.

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

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

The term research, for this purpose, doesn't include activities of a type normally conducted as an incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment, buildings, etc. In

addition, the term fundamental research doesn't include research conducted for the primary purpose of commercial or industrial application.

**Gains and losses from disposition of property.** Also excluded from UBTI are gains or losses from the sale, exchange, or other disposition of property other than:

1. Stock in trade or other property of a kind that would properly be includible in inventory if on hand at the close of the tax year,
2. Property held primarily for sale to customers in the ordinary course of a trade or business, or
3. Cutting of timber that an organization has elected to consider as a sale or exchange of the timber.

It should be noted that the last exception relates only to cut timber. The sale, exchange, or other disposition of standing

timber is excluded from the computation of unrelated business income, unless it constitutes property held for sale to customers in the ordinary course of business.

***Lapse or termination of options.*** Any gain from the lapse or termination of options to buy or sell securities is excluded from UBTI. The exclusion applies only if the option is written in connection with the exempt organization's investment activities.

Therefore, this exclusion isn't available if the organization is engaged in the trade or business of writing options or the options are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business.

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

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

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

This exclusion applies only if the following requirements are met.

1. The trade or business must have been operated by the order or by the institution before May 27, 1959.

2. The trade or business must provide services under a license issued by a federal regulatory agency.
3. More than 90% of the net income from the business for the tax year must be devoted to religious, charitable, or educational purposes that constitute the basis for the religious order's exemption.
4. The rates or other charges for these services must be fully competitive with the rates or other charges of similar taxable businesses. Rates or other charges for these services will be considered as fully competitive if they are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.
- 5.

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

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

## **Dues of Agricultural Organizations and Business Leagues**

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

the associate member dues may be unrelated business income.

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

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

## **Deductions**

To qualify as allowable deductions in computing UBTI, the expenses, depreciation, and similar items must generally be allowable

income tax deductions that are directly connected with carrying on the unrelated trade or business to which they relate. They can't be directly connected with excluded income.

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

## **Directly Connected**

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

**Expenses attributable solely to unrelated business.** Expenses, depreciation, and similar items attributable solely to the conduct of an unrelated business are proximately and primarily related to that



business and qualify for deduction to the extent that they are otherwise allowable income tax deductions.

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

**Expenses attributable to dual use of facilities or personnel.** When facilities or personnel are used both to conduct exempt functions and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis. The part of an item allocated to the unrelated trade or business is proximately and primarily related to that business and is allowable as a deduction in computing UBTI if the expense is otherwise an allowable income tax deduction.

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

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

the facilities and personnel it makes available under the contract.

**Example 2.** An exempt organization with gross income from an unrelated trade or business pays its president \$90,000 a year. The president devotes approximately 10% of his time to the unrelated business. To figure the organization's UBTI, a deduction of \$9,000 ( $\$90,000 \times 10\%$ ) is allowed for the salary paid to its president.

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

they don't qualify as directly connected with that business.

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

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

The amount treated as directly connected is the smaller of:

1. The excess of these expenses, depreciation, and similar items over

the income from, or attributable to, the exempt activity; or

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

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

## **Exploitation of Exempt Activity—Advertising Sales**

The sale of advertising in a periodical of an exempt organization that contains editorial material related to the accomplishment of the organization's exempt purpose is an unrelated business that exploits an exempt activity, the circulation, and readership of the periodical. Therefore, in addition to direct advertising costs, exempt activity costs (expenses, depreciation, and similar expenses attributable to the production and distribution

of the editorial or readership content) can be treated as directly connected with the conduct of the advertising activity. (See Expenses attributable to exploitation of exempt activities under *Directly Connected*, earlier.)

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

<b>IF gross advertising income is . . .</b>	<b>THEN UBTI is . . .</b>
more than direct advertising costs	the excess advertising income, reduced (but not below zero) by the excess, if any, of readership costs over circulation income.

equal to or less than direct advertising costs	<p>zero.</p> <p>Circulation income and readership costs aren't taken into account.</p>
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The terms used in the chart are explained in the following discussions.

## **Periodical Income**

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

**Circulation income.** This is all the income from the production, distribution, or circulation of an exempt organization's periodical (other than gross advertising income). It includes all amounts from the sale or distribution of the readership content of

the periodical, such as income from subscriptions. It also includes allocable membership receipts if the right to receive the periodical is associated with a membership or similar status in the organization.

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

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



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

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

<b>IF . . .</b>	<b>THEN the amount used to allocate membership receipts is . . .</b>
20% or more of the total circulation consists of sales to nonmembers	the subscription price charged nonmembers.

the above condition doesn't apply, and 20% or more of the members pay reduced dues because they do not receive the periodical	the reduction in dues for a member not receiving the periodical.
neither of the above conditions applies	<p>the membership receipts multiplied by this fraction:</p> $\frac{\text{Total periodical costs}}{\text{Total periodical costs} + \text{Cost of other exempt activities}}$

**Example 1.** U is an exempt scientific organization with 10,000 members who pay annual dues of \$15. One of U's activities is publishing a monthly periodical distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmembers, who subscribe for \$10 a year.

Since the nonmember circulation of U's periodical represents one-third (more than 20%) of its total circulation, the subscription price charged to nonmembers is used to determine the part of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts are \$100,000 (\$10 times 10,000 members), and U's total circulation income for the periodical is \$150,000 (\$100,000 from members plus \$50,000 from sales to nonmembers).

**Example 2.** Assume the same facts except that U sells only 500 copies of its periodical to nonmembers, at a price of \$10 a year. Assume also that U's members may elect not to receive the periodical, in which case their dues are reduced from \$15 a year to \$6 a year, and that only 3,000 members elect to receive the periodical and pay the full dues of \$15 a year. U's stated subscription price of \$9 to members consistently results in an excess of total income (including gross advertising

income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represent only 14% of the 3,500 copies distributed, the \$10 subscription price charged to nonmembers isn't used to determine the part of membership receipts allocable to the periodical. Instead, since 70% of the members elect not to receive the periodical and pay \$9 less per year in dues, the \$9 price is used to determine the subscription price charged to members. Thus, the allocable membership receipts will be \$9 per member, or \$27,000 (\$9 times 3,000 copies). U's total circulation income is \$32,000 (\$27,000 plus the \$5,000 from nonmember subscriptions).

## **Periodical Costs**

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

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

In addition, direct advertising costs include the part of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includible in mechanical and distribution costs ordinarily employed in business-paper and consumer-publication accounting provide a guide for the computation. Accordingly, the mechanical and distribution costs include the

part of the costs and other expenses of composition, press work, binding, mailing (including paper and wrappers used for mailing), and bulk postage attributable to the advertising lineage of the publication.

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

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

**Costs partly attributable to other activities.** Deductions properly attributable to exempt activities other than publishing the periodical may not be allocated to the periodical. When expenses are attributable

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

## **Consolidated Periodicals**

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

treatment can be changed only with the consent of the IRS.

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

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

Whether the publication of a periodical is an activity engaged in for profit can be determined only by all the facts and circumstances in each case. The facts and circumstances must show that the organization carries on the activity for economic profit, although there may not be a profit in a particular year. For example, if an organization begins publishing a new periodical whose total costs exceed total income in the start-up years because of lack



of advertising sales, that doesn't mean that the organization didn't have as its objective an economic profit. The organization may establish that it had this objective by showing it can reasonably expect advertising sales to increase, so that total income will exceed costs within a reasonable time.

**Example.** Y, an exempt trade association, publishes three periodicals that it distributes to its members: a weekly newsletter, a monthly magazine, and a quarterly journal. Both the monthly magazine and the quarterly journal contain advertising that accounts for gross advertising income equal to more than 25% of their respective readership costs. Similarly, the total income attributable to each periodical has exceeded the total deductions attributable to each periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price isn't intended to cover the cost of publication.

The newsletter is a service that Y distributes to all of its members in an effort to keep them informed of changes occurring in the business world. It is not engaged in for profit.

Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its UBTI. It may not consolidate the income and deductions from the newsletter with the income and deductions of its other periodicals, since the newsletter isn't published for the production of income.

## **Modifications**

**Net operating loss (NOL).** An NOL arises when allowable deductions exceed gross unrelated trade or business income. Subject to modifications described in section 172, the NOL is allowed as a deduction against unrelated business taxable income for a tax year to which the NOL can be carried, as described below. The NOL for any tax year,

the carryovers of NOLs, and the NOL deduction are determined without taking into account any amount of income or deduction that is specifically excluded in computing UBTI. For example, a loss from an unrelated trade or business isn't diminished because the organization received dividend income.

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

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

**NOLs arising before 2018.** Prior to the addition of section 512(b)(6), an exempt organization would compute its NOL (if any)

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

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

## **NOLs arising in tax years after 2017.**

Section 512(a)(6) requires an organization with more than one unrelated trade or business to calculate UBTI in any tax year beginning after 2017, including for purposes of determining any

NOL (post-2017 NOL) or applying any post-2017 NOL deduction, separately with respect to each such trade or business.

The Tax Cuts and Jobs Act (P.L.115-97, section 13302) amended section 172(b) to eliminate both the expiration of NOL carryforwards and the ability to carryback NOLs to earlier tax years. Certain farming and insurance company losses are exceptions and can be carried back as described in section 172(b). See Publication 225, Farmer's Tax Guide; Publication 536, Net Operating Losses; or Publication 542, Corporations; for additional information.

However, the CARES Act added section 172(b) (1)(D), which provides for carryback of NOLs arising in 2018, 2019, and 2020 to each of the 5 years preceding the tax year in which the NOL arose. An organization that wishes to carry these NOLs forward must waive the carryback. See the Instructions for Form 990-T for more information.

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

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

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

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

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

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

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

An exempt trust that is subject to the unrelated business income tax at trust rates is generally allowed a deduction for charitable contributions in the same amounts as allowed for individuals. However, the limit on the deduction is determined in relation to the trust's UBTI computed without regard to the deduction, rather than in relation to adjusted gross income.

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



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

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

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

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

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

***Example.*** X is an association of churches and is divided into local units A, B, C, and D. Last year, A, B, C, and D derived gross income of, respectively, \$1,200, \$800, \$1,500, and \$700 from unrelated businesses

that they regularly conduct. X may claim a specific deduction of \$1,000 with respect to A, \$800 with respect to B, \$1,000 with respect to C, and \$700 with respect to D.

## **Partnership Income or Loss**

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

512(a)(6) for aggregating income from partnerships and debt-financed income from partnerships.

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

***Example.*** An exempt educational organization is a partner in a partnership that operates a factory. The partnership also holds

stock in a corporation. The exempt organization must include its share of the gross income from operating the factory in its UBTI but may exclude its share of any dividends the partnership received from the corporation.

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

## **S Corporation Income or Loss**

An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, and losses in figuring UBTI, regardless of the actual source or nature of the income, deductions, and losses. For example, the organization's

share of the S corporation's interest and dividend income will be taxable, even though interest and dividends are normally excluded from UBTI. The organization must also take into account its gain or loss on the sale or other disposition of the S corporation stock in figuring UBTI.

## **Special Rules for Foreign Organizations**

The UBTI of a foreign organization exempt from tax under section 501(a) consists of the organization's:

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

income is derived from sources within the United States.

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see sections 861 through 865 and the related regulations.

## **Special Rules for Social Clubs, VEBAs, and SUBs**

The following discussion applies to:

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

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

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



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

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

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

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

income set aside to provide for the payment of life, sick, accident, or other benefits.

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

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

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

having been set aside in the tax year for which the return was filed. The income set aside must have been includible in gross income for that earlier year.

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

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

## **Special Rules for Veterans' Organizations**

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

## **Income From Controlled Organizations**

The exclusions for interest, annuities, royalties, and rents, explained earlier in this chapter under Income, may not apply to a

payment of these items received by a controlling organization from its controlled organization. The payment is included in the controlling organization's UBTI to the extent it reduced the net unrelated income (or increased the net unrelated loss) of the controlled organization. All deductions of the controlling organization directly connected with the amount included in its UBTI are allowed.

**Excess qualifying specified payments.**

Excess qualifying specified payments received or accrued from a controlled entity are included in a controlling exempt organization's UBTI only to the extent of the amount that exceeds that would have been paid or accrued if the payments had been determined under section 482. Qualifying specified payments means any payments of interest, annuities, royalties, or rents received or accrued from the controlled organization pursuant to a binding written contract in

effect on August 17, 2006, or to a contract which is a renewal, under substantially similar terms of a binding written contract in effect on August 17, 2006, and the payments are received or accrued after December 31, 2014.

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

## ***Addition to tax for valuation***

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

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

***Net unrelated loss.*** This is:

- For an exempt organization, its NOL, or
- For a nonexempt organization, the part of its NOL that would be its NOL if it were exempt and had the same exempt

purposes as the controlling organization.

**Control.** An organization is controlled if:

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

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

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