I. INTRODUCTION

One of the benefits of being classified as a Section 501(c)(3) organization for federal income tax purposes is that Section 501(c)(3) organizations, as a general rule, are exempt from federal income taxation. [See Section 501(a) of the Internal Revenue Code (“Code”)]. Until 1951, the exemption from federal income taxation for charitable organizations extended to all income. For example, in 1947 H.T. Sorg conceived the idea of forming a charitable corporation that would buy and operate a macaroni manufacturer and would contribute the proceeds from the business to New York University to be used for its law school. Mr. Sorg received support for his idea and in 1947 C.F. Mueller Company, a Delaware corporation, which provided in its corporate charter that it was organized for charitable purposes, was formed for the purpose of acquiring the stock of C.F. Mueller Company, a New Jersey corporation. The New Jersey corporation had been in existence since 1867 as a for profit corporation. However, in 1946 Henry Mueller, the president of the New Jersey corporation and its major shareholder, died. The Delaware corporation was successful in acquiring all of the stock of the New Jersey corporation. The purchase price was entirely paid from the proceeds of a loan from Prudential Insurance Company. C.F. Mueller Co. v. Commissioner, 14 T.C. 922 (1950); rev’d 190 F. 2d 120 (1951 3rd Cir).

The Internal Revenue Service (“IRS”) challenged the exempt status of C.F. Mueller. Although, until that time, the case law held that a corporation organized for charitable purposes could maintain a business that was carried on for profit. Mueller 190 F.2d 120. What both the IRS and the Tax Court objected to in the Mueller case was that the new corporation was not the entity that was actually engaged in the exempt educational activities, rather it was formed for the sole purpose of carrying on an otherwise for profit business. Mueller, 14 T.C. 922. Accordingly, the Tax Court ruled in favor of the IRS and revoked Mueller’s tax-exempt status. Mueller appealed and the Third Circuit Court of Appeals based on the law in effect during the tax years in question reversed the Tax Court.
In response to the Mueller case and those of other educational institutions which were viewed as “unfair competition” by tax-exempt organization, Congress, in 1950, enacted as part of the Revenue Act an income tax on the income derived by tax exempt organizations from unrelated trades or businesses that were regularly carried on by a number of tax exempt organizations. [See H.R. Rept. No. 2819, 81st Cong, 2nd Sess, reprinted in 1950-1 C.B. at page 380, see pages 408-410, and S. Rept. 2375, Cong, 2nd Sess, reprinted in 1950-1 C.B. at page 483, see pages 502-504]. Congress was clear, though, that its intention was merely to tax the income from such activity, and not to revoke the organization’s exempt status. *Id.* at pp 409 and 505.

Thus, since January 1, 1951, Section 501(c)(3) organizations, while generally exempt from income taxes, are not exempt from income tax on their Unrelated Business Taxable Income (“UBTI”). [Treasury Regulation Section 1.513-1(b) and Section 501(b) of the Code].

II. **TAX RATE FOR UBTI**

If a Section 501(c)(3) organization has UBTI, the UBTI will be taxed at either the corporate rates or trust rates, depending on what type of entity the organization is for state law purposes. If the organization is a corporation for state law purposes, and the organization has UBTI, the organization will be subject to the corporate tax rates on its UBTI. [Section 511(a) of the Code]. The corporate tax rates are as follows:

<table>
<thead>
<tr>
<th>INCOME</th>
<th>RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $50,000 of taxable income</td>
<td>15%</td>
</tr>
<tr>
<td>Taxable income over $50,000 but not over $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>Taxable income over $75,000 but not over $10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>Taxable income over $10,000,000</td>
<td>35%</td>
</tr>
</tbody>
</table>
If the organization is a trust for state law purposes, and the organization has UBTI, the organization will be subject to the trust tax rates on its UBTI. [Section 511(b) of the Code]. The trust tax rates for 2011 are as follows:

<table>
<thead>
<tr>
<th>INCOME</th>
<th>RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $2,300 of taxable income</td>
<td>15%</td>
</tr>
<tr>
<td>Taxable income over $2,300 but not over $5,450</td>
<td>25%</td>
</tr>
<tr>
<td>Taxable income over $5,450 but not over $8,300</td>
<td>28%</td>
</tr>
<tr>
<td>Taxable income over $8,300 but not over $11,350</td>
<td>33%</td>
</tr>
<tr>
<td>Taxable income over $11,350</td>
<td>35%</td>
</tr>
</tbody>
</table>


III. WHAT IS UBTI?

Section 512(a) of the Code provides that UBTI means the gross income derived by an organization from any Unrelated Trade or Business (“UTB”) that is regularly carried on by the organization, less expenditures that are incurred with the carrying on of such trade or business, adjusted for certain modifications. Thus, for a Section 501(c)(3) organization to have UBTI, the organization must be engaged in (i) a trade or business that is (ii) unrelated to the organization’s exempt purpose, and (iii) the organization must be regularly carrying on the UTB.

A. WHAT IS A TRADE OR BUSINESS?

For purposes of Section 513(a) of the Code, the term “trade or business” includes any activity which is carried on for the production of income from the sale of goods or the performance of services. [Section 513(c) of the Code]. Treasury Regulation Section 1.513-1(b) provides that any activity of an exempt organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute a trade or business within the meaning of Section 162 is a trade or business for purposes of Section 513. The United States Supreme Court relying on both the language in Section 513(c) of the Code and Treasury Regulation Section 1-513-1(b) in *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986), held that the sale of life insurance policies by the American Bar Endowment to raise funds for its charitable purposes
constituted a trade or business. The Supreme Court noted that the sale of the life insurance policies encompassed both the sale of goods and the sale of services. In short, if money is received from the sale of goods or the sale of services, for purposes of Section 513 the money is received in connection with a trade or business.

B. **WHAT IS AN UTB?**

1. **General Rule**

If a tax-exempt organization is carrying on a trade or business, the income from that trade or business will not result in UBTI, unless the trade or business is an UTB that is being conducted on a regular basis. An UTB is any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function, constituting the basis for its exemption under Section 501. [Section 513(a) of the Code].

A trade or business, in turn, is not substantially related to the organization’s exempt purpose unless the conduct of the business activities has a causal relationship to the achievement of the organization’s exempt purpose. [Treasury Regulation Section 1.513-1(d)(2)]. The determination of whether there is a causal relationship between the achievement of the exempt purpose and the business activity is based on the particular facts and circumstances surrounding the operation of the trade or business. *Id.* The facts and circumstances to be considered are the size and extent of the activities in relation to the nature and extent of the function which they purport to serve. *Id.*

For example, assume a Section 501(c)(3) organization operates after school programs in the performing arts. The organization presents performances by its students and derives income from ticket sales for the performances. The students’ participation in performances is an essential part of the training program. Since the income is derived from an activity that contributes importantly to the accomplishment of the organization’s exempt purposes, the income derived from the ticket sales is not derived from an UTB. [Treasury Regulation Section 1.513-1(d)(4)(i) Example(1)].
Another example of a related trade or business involves a private university that has a regular faculty and a regularly enrolled student body. During the academic year the organization sponsors the appearances of professional theater companies and symphony orchestras which present drama and musical performances for the organization’s students and faculty members. Members of the general public are also allowed to attend. The organization advertises these performances and supervises advance ticket sales at various places, including the organization’s cafeteria and bookstore. The presentation of these productions contributes importantly to the organization’s educational and cultural purpose. Thus, the income generated from these performances is not income from an UTB. [Treasury Regulation Section 1.513-1(d)(4)(iv) Example 2].

An example of a related trade or business that involves the sale of goods is the sale by a Section 501(c)(3) organization, organized to rehabilitate handicapped persons, of products produced by such persons. [Treasury Regulation Section 1.513-1(d)(4)(ii)].

On the other hand, an example where a causal relationship does not exist is the operating of a pet boarding and grooming facility by a tax-exempt organization whose exempt purpose was the prevention of cruelty to animals. In Revenue Ruling 73-587, 1973-2 C.B. 192, the IRS ruled that the providing of boarding and grooming services was an ordinary commercial service that did not have a causal relationship to the prevention of cruelty to animals.

An added complication in reviewing the facts and circumstances to determine if a trade or business has a causal relationship to the tax-exempt purpose is that sometimes the activity has a causal relationship and sometimes it does not. [Treasury Regulation Section 1.513-1(d)(4)(iii)]. In these situations, the organization must differentiate between income generated from the trade or business that has a causal relationship to the organization’s tax-exempt purpose and income generated from the trade or business that does not have a causal relationship to the organization’s tax-exempt purpose. An example of this would be a theater operated by a Section 501(c)(3) organization that is a museum. When the theater is used during the normal operating hours of the museum to show educational films related to the museum’s exhibits, the income from the showing of
the films would be income related to the organization’s exempt purpose. If after hours the organization showed films for public entertainment, the income generated from the showing of those films would be income from an UTB. *Id.*

Thus, where income is derived by a Section 501(c)(3) organization from activities which are in part related to the organization’s purpose but which are conducted on a larger scale than is reasonably necessary for the organization’s exempt functions, the income attributable to the portion of the activities in excess of the needs of the exempt function constitutes income from the conduct of an UTB. [See Treasury Regulation Section 1.513-1(d)(3)].

Two examples that demonstrate the need to compare the conduct of the business activities with the causal relationship to the Section 501(c)(3) organization’s exempt purpose involve income derived from the sale of advertisements. One example involves the sale of advertising time by a Section 501(c)(3) organization whose exempt purpose is the advancement of public interest in classical music. The exempt organization owns and operates a radio station. The organization sells advertising time. The second example involves a Section 501(c)(3) organization that is a private university. The university provides facilities, instruction, and supervision for a campus newspaper operated by the students. In addition to publishing news items and editorial commentary, the newspaper publishes paid advertisements. The solicitation, sale and publication of the advertising are conducted by students under the supervision and instruction of the university. As to the organization that operates the radio station, the advertising income is income generated from an UTB. As to the university, the income generated from the advertising is related to the university’s exempt purpose of educating and training the students. Thus, the advertising income generated by the school newspaper is income generated from a business that is related to the university’s exempt purpose. [Treasury Regulation Section 1.513-1(d)(iv) Examples (4) and (5)].

2. **Rulings Regarding UTB and Museums**

In Revenue Ruling 73-104, 1973-1 C.B. 263, the IRS ruled on whether the sale of greeting card reproductions of artworks by an art museum was an UTB. The museum
was devoted to the exhibition of modern art. The museum offered greeting cards for sale that displayed printed reproductions of selected works from the museum’s collection and from other art collections. The museum was exempt from taxation as an educational organization on the basis of its ownership, maintenance and exhibition for public viewing of works of art. The IRS determined that the sale of greeting cards displaying reproductions of art works contributed importantly to the achievement of the museum’s exempt purpose by stimulating and enhancing public awareness, interest and appreciation of art. Thus, the IRS concluded that the sale of the greeting cards was not an UTB.

In Revenue Ruling 73-105, 1973-1 C.B. 264, the IRS ruled on whether the sale of scientific books and city souvenirs by a museum of folk art that was exempt from taxation constituted an UTB. In this case, the exempt organization maintained and operated an art museum devoted to the exhibition of American folk art. The organization operated a gift shop that offered the following items for sale: (1) reproductions of works in the museum’s own collection and reproductions of artistic works from the collections of other art museums (the reproductions were in the form of prints, greeting cards, and slides); (2) metal, wood, and ceramic copies of American folk art objects from the museum’s own collection and similar copies of art objects from other collections of art works; and (3) instructional literature concerning the history and development of art, and in particular folk art. The gift shop also sold scientific books and various souvenirs relating to the city in which the museum was located. Again, the IRS stated that the art museum was exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of an art collection. The IRS also determined that the sale of reproductions of works from the museum’s own collection and reproductions of artistic works not owned by the museum contributed importantly to the achievement of the museum’s exempt educational purpose of making works of art familiar to a broader segment of the public, thereby enhancing the public’s understanding and appreciation of art. The IRS also found the same to be true with respect to literature relating to art. Thus, the IRS ruled that the sales activities relating to the sale of the art reproductions and the books on art did not constitute an UTB. The IRS, however, stated
that scientific books and souvenir items relating to the city where the museum was located had no causal relationship to art or to artistic endeavor, and that the sale of these items did not contribute importantly to the accomplishments of the organization’s exempt educational purpose which was to enhance the public’s understanding and appreciation of art. Thus, the IRS ruled that the sale of the scientific books and the souvenir items relating to the city was an UTB.

In Private Letter Ruling 8326008, the IRS was asked to rule on whether a museum’s sales of reproductions of artwork and of artistic utilitarian items and clothes in its collection as well as sales of original art or crafts was an UTB. The organization was founded for the purposes of establishing and maintaining a museum and library of art, of encouraging and developing the study of art, and the application of art to manufacture and practical life. The organization maintained an art museum and a library. The organization also operated a gift shop. The IRS ruled that the sales of the reproductions of artwork and of the artistic utilitarian items and clothes was substantially related to the organization’s exempt purpose, and, thus, was not an UTB. The IRS, however, ruled that the sale of original artwork was not in furtherance of the organization’s exempt purpose, and that the sale of those items was an UTB.

Private Letter Ruling 8328009 also involved the sale of various items in a museum gift shop. In Private Letter Ruling 8328009, the IRS ruled that the sale of mugs, dish towels, ashtrays, t-shirts, decals, paper, and shopping bags that had the museum’s logo on them but not reproductions of items in the museum’s collection was an UTB.

In Private Letter Ruling 8326003, the IRS was asked to rule on whether the sale of puzzles, toys, and other games by an art museum was an UTB. The puzzles, kites, and games featured various artistic themes. In this Private Letter Ruling, the IRS said that the sale of children’s interpretative teaching items that have artistic themes is in furtherance of the organization’s educational purposes. Thus, the sale of these items is not an UTB.
3. **Exceptions to the General Rule**

Certain activities which are unrelated to an organization’s exempt purpose and which are regularly carried on are nonetheless not treated as being UTBs. These trades and businesses include the following:

1. a trade or business in which substantially all the work is performed for the 501(c)(3) organization without compensation;
2. a trade or business which is carried on by the organization primarily for the convenience of its members, students, patients, officers or employees; and
3. a trade or business which involves the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions. [Section 513(a) of the Code].

An example of a trade or business in which substantially all of the work is performed for the organization without compensation would be the operation of a retail store by unpaid volunteers at a Section 501(c)(3) organization’s medical clinic. [Treasury Regulation Section 1.513-2(e)]. An example of a trade or business carried on by a Section 501(c)(3) organization for the convenience of its members, students, patients or employees would be the operation of a laundry operated by a college for the purpose of laundering dormitory linens. *Id.* An example of a trade or business which consists of selling merchandise which has been received by the organization as gifts or contributions would be thrift shops operated by Section 501(c)(3) organizations. *Id.*

a. **Qualified Public Entertainment Activities**

Additionally, an UTB does not include “qualified public entertainment activities” carried on by a Section 501(c)(3) organization which regularly conducts as one of its substantial exempt purposes an agricultural and educational fair or exposition. A “qualified public entertainment activity” is a public entertainment activity which is conducted: (i) in conjunction with an international, national, state or local fair or
exposition; (ii) in accordance with the provisions of a State law which permits the activity to be operated or conducted solely by such organization or by an agency, instrumentality, or political subdivision of such state; or (iii) in accordance with the provisions of state law which permit such organization to be granted a license to conduct not more than twenty (20) days of such activity on payment to the state of a lower percentage of the revenue from such licensed activity than the state requires from non-exempt organizations. A public entertainment activity is any entertainment or recreational activity of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes, including, but not limited to any activity one of the purposes of which is to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment. [Section 513(d) of the Code].

b. Bingo Games

Also, excluded as an UTB is the trade or business of conducting bingo games. [Section 513(f) of the Code]. For purposes of Section 513, a bingo game is a game of chance played with cards that are generally printed with five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a pre-selected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the pre-selected pattern wins the game. [Treasury Regulation Section 1.513-5(d)]. Additionally, to be not treated as an UTB the bingo activity must not be an activity that is ordinarily carried out on a commercial basis, and the conduct of the bingo activity must not violate State or local law. Id. Thus, if bingo is prohibited by State law, the conduct of a bingo game by a Section 501(c)(3) organization in that state would be an UTB. Additionally, if bingo games are allowed to be carried on by commercial enterprises in a state, the conduct of a bingo game in that state by a Section 501(c)(3) organization would be the conduct of an UTB. Even if the conduct of the bingo activity satisfies the requirements of Section 513(f) of the Code, if the bingo activity is found by the IRS to be the organization’s primary activity, the organization may jeopardize its tax-exempt status. [See PLR 201108048 in which the IRS revoked the
taxpayer’s tax-exempt status after determining that the taxpayer’s primary activity was running bingo games."

The exemption for bingo is specifically limited to bingo, it does not extend to keno games, dice games, card games, and lotteries. [Treasury Regulation Section 1.513-5(d)] It also does not extend to video bingo or to the sale of incidental bingo gear (i.e., daubers and hats). See Private Letter Ruling 200840048. However, even if the bingo exception does not apply, revenue from another game of chance still may not be treated as income from an unrelated trade or business if the bingo activity is carried on by substantially all volunteer labor. [See IRS Publication 3079 Tax-Exempt Organizations and Gaming in which the IRS states that “substantially all means eighty-five percent (85%).”]

c. Solicitations Using Low Cost Articles

Another activity that is excluded from being an UTB is the distribution of low cost articles, provided the distribution is incidental to the solicitation of charitable contributions. [Section 513(h) of the Code]. “Low Cost” means any article which has a cost not in excess of $5, indexed, to the organization which distributes such item (or on whose behalf such item is distributed. The current indexed amount for low cost items is $9.60 [See Revenue Procedure 2009-50, 2009-45 I.R.B. 617, Section 3.25]. Additionally, if more than one item is distributed by or on behalf of an organization to a single person in any calendar year, the aggregate of the items so distributed shall be treated as one item for purposes of determining if the items are low cost. [Section 513h(2)(B) of the Code].

For purposes of Section 513(h) the term “incidental to the solicitation” means the distribution is not made at the request of the distributee, the distribution is made without the express consent of the distributee; and the articles distributed are accompanied by a request for a charitable contribution by the distributee to such organization, and a statement that the distributee may retain the low cost article regardless of whether such distributee makes a charitable contribution to such organization [Section 513(h)(3) of the
Hence, the explanation for the unsolicited return address labels received along with the request for a donation to the sending Section 501(c)(3) organization.

Also, the exchange or rental of donors or members lists between 501(c)(3) organizations does not constitute an UTB. [Section 513(h) of the Code].

d. **Qualified Sponsorships**

Additionally, “qualified sponsorship payments” are excepted out as an UTB. A “qualified sponsorship payment” is a payment made by a person engaged in a trade or business with respect to which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgement of the name or logo of such person’s trade or business in connection with the activities of the organization that receives such payment. [Section 513(i) of the Code]. A “substantial return benefit” means any benefit other than a use or acknowledgement benefit or a disregarded benefit. [Treasury Regulation Section 1.513-4(c)(2)(i)]. The use or acknowledgement benefit includes the use or acknowledgement of the name or logo of the payor’s business in connection with the organization’s activities. Use or acknowledgement does not include advertising but may include the following: (i) slogans that do not contain qualitative or comparative descriptions of the payor’s products, services, or facilities; and (ii) a list of the payor’s locations, telephone numbers, or internet address. [Treasury Regulation Section 1.513-(c)(2)(iv)]. Advertising for purposes of determining whether more than an acknowledgement has occurred means any message or programming material which promotes or markets any trade or business or any service or facility or product. Advertising includes messages containing qualitative or comparative language, price information, or an endorsement. [Treasury Regulation Section 1.513-(c)(2)(v)]. A message that contains both an acknowledgement and advertising is advertising. *Id.*

Additionally, a benefit that is more than the use or acknowledgement of the name of the payor will be disregarded for purposes of determining if the payment is a qualified sponsorship payment, if the aggregate fair market value of all the benefits provided to the payor during the Section 501(c)(3) organization’s taxable year is not more than two
percent (2%) of the payment. [Treasury Regulation Section 1.513-4(c)(2)(ii)]. If the aggregated fair market value of the benefits exceeds two percent (2%) of the amount of the sponsorship payment, the entire fair market value of the benefits, not merely the excess amount, is a substantial return benefit. Id. For purposes of determining the fair market value of the benefit received by the payor, fair market value means the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit, neither being under any compulsion to enter into the arrangement, and both having reasonable knowledge of relevant facts. [Treasury Regulation Section 1.513-4(d)(1)(ii)]. For purposes of determining fair market value, the valuation date is generally the date the benefit is provided. [Treasury Regulation Section 1.513-4(d)(1)(iii)]. If, however, the payor and the Section 501(c)(3) organization enter into a binding, written sponsorship contract, the valuation date for purposes of determining the value of the return benefit is the date the contract is entered into. Id.

Assume on June 30, Year 1, Corporation C and Section 501(c)(3) organization Y enter into a five year binding, written contract that is to be effective from January 1, Year 2, through December 31, Year 6. The contract provides that C will make an annual payment of $100,000 to Y, and in return C will return no benefit other than advertising. On June 30, Year 1, the fair market value of the advertising benefit to be provided is $1,500. Under the disregarded benefit rule the fair market value of the benefit to be received, $1,500, is less than two percent (2%) of the payment made, $2,000 (2% of $100,000). On January 1, Year 2, C makes a payment of $100,000 to Y. On January 1, Year 2 the fair market value of the advertising benefit is $2,500. However, since the parties entered into a binding, written contract, the valuation date for the benefit received is the contract date. Therefore, regardless of the fair market value of the benefit received by C during the term of the contract, the payments made by C will be qualified sponsorship payments. [Treasury Regulation Section 1.513-4(d)(1)(iv) Example 1]. If, however, the contract provided for the initial payment of $100,000 and subsequent payments of $10,000, the payments made in Year 3 through Year 6 would be a combination of a qualified sponsorship payment and a payment received by Y in an UTB.
The reason for this is that the value of the advertising determined at the time the contract was entered into was $1,500. However, two percent (2%) of $10,000 is $200. Thus, $1,500 of each $10,000 payment is a payment received in an UTB and $8,500 of each payment is a qualified sponsorship payment. [Treasury Regulation Section 1.513-4(d)(1)(iv) Example 2].

One popular form of fundraising event is the road race (i.e., 10k, 15k, half-marathons or marathons). Often corporate drink companies will sponsor the event with the Section 501(c)(3) organization. For example, sports drink company C and local Section 501(c)(3) organization Y sponsor a 10k race. C provides the cups and drinks for the racers. C also gives Y the prizes to be awarded in the different race categories. Y recognizes the assistance of C by listing C in the promotional fliers for the race, the newspaper advertisements, and on the T-shirts to be given to the racers. The name of the event is the CY 10k Race. Y’s activities towards C constitute acknowledgement of C’s sponsorship. Thus, the contributions of the drinks, cups, and prizes by C are a qualified sponsorship payment. Y, therefore, has no income from an UTB. [Treasury Regulation Section 1.513-4(f) Example 1].

A common event by a local museum is the showing of works by a particular artist such as Picasso. To be able to do this, though, the museum may find a corporation to help sponsor the exhibition. Say local museum, M, a Section 501(c)(3) organization gets corporation C to underwrite the Picasso exhibit. In exchange for underwriting the exhibit, M recognizes C’s support by using C’s name and logo in materials publicizing the exhibition, which include banners, postures, brochures and public service announcements. M in gratitude for C’s support hosts a dinner for C’s executives. The fair market value of the dinner exceeds two percent (2%) of the total payment made by C. M’s use of C’s name and logo in connection with the exhibition constitutes acknowledgement of C’s support. However, because the cost of the dinner exceeds two percent (2%) of the total payment made by C, the dinner is a substantial return benefit. Thus, only the portion of the payment that exceeds the fair market value of the dinner is a
qualified sponsorship payment. The remaining portion of the payment is income received from an UTB. [Treasury Regulation Section 1.513-4(f) Example 2].

T, a Section 501(c)(3) organization, organizes a youth baseball team to play in a city league. C corporation, which operates a pizza chain, provides the uniforms for the players. The uniforms have C’s name and logo on them. T gives C’s employees who come out to support T’s team flags bearing T’s name. The fair market value of the flags is less than two percent (2%) of the value of the funding provided by C. The total funding provided by C is a qualified sponsorship payment. [Treasury Regulation Section 1.513-4(f) Example 5].

U is a private university. A soft-drink manufacturer, C, enters into a binding, written contract with U that provides that U will make a $500,000 contribution to the college in exchange for U naming a science competition after C. The contract also provides that U will allow C to be the exclusive provider of soft drink sales on campus. The fair market value of the exclusive provider component of the contract exceeds $10,000 (2% of $500,000). U’s use of C’s name in the science competition constitutes acknowledgement of the sponsorship. However, the exclusive provider arrangement is a substantial return benefit to C. Only that portion of the $500,000, if any, that exceeds the fair market value of the exclusive provider benefit is a qualified sponsorship payment. [Treasury Regulation Section 1.513-4(f) Example 6].

S, a symphony orchestra that is a Section 501(c)(3) organization, performs a series of concerts throughout the year. S arranges to have a local business be the sponsor for each concert. The cost of being the sponsor is $15,000. S acknowledges the support of the business sponsoring the concert in the program for that concert. S also provides the business sponsor’s name on the posters advertising the concert. S provides the sponsor with two complimentary tickets to the particular concert, and a free half-page for advertising its business. The providing of the complimentary tickets, and the half page for free advertising constitute a substantial return benefit to the local business. Thus, only that portion of the $15,000 that exceeds the combined fair market value of the
complimentary tickets and the free half page of advertising constitute a qualified sponsorship payment. [Treasury Regulation Section 1.513-4(f) Example 8].

e. **Travel Tours**

Travel tour activities that are organized by a Section 501(c)(3) organization for the purpose of producing income and that are not substantially related to the organization’s exempt purpose constitute an UTB. [Treasury Regulation Section 1.513-7(a)]. Whether a travel tour is related to a Section 501(c)(3) organization’s exempt purpose is determined by looking at all the relevant facts and circumstances, including how a travel tour is developed, promoted and operated. *Id.*

One common group that sponsors travel tours are Section 501(c)(3) university alumni associations. Assume UA is a Section 501(c)(3) university alumni association that bases its exemption on its continuing educational activities. UA organizes ten travel tours a year. The tour is open to members of UA and their guests. UA works with travel agency T. Members of UA pay T $X to participate on a tour. T pays UA a portion of the $X paid by each member. A faculty member of U joins the tour, but the tour does not provide for any scheduled instruction or curriculum. In this situation the travel tour does not further UA’s exempt educational purpose. Accordingly, the conducting of the travel tours is an UTB. [Treasury Regulation Section 1.513-7(a) Example 1].

On the other hand, there is N, a Section 501(c)(3) organization that was formed for the purpose of educating individuals about the geography and culture of the United States. N engages in a number of activities to achieve its exempt purpose including study tours to national parks and other locations in the United States. The study tours are conducted by teachers who are certified by their states’ boards of education. The tours are directed towards students enrolled in degree programs at educational institutions but are open to all persons who agree to participate in the study program. Five or six hours each day are devoted to organized study, and lectures. Examinations are given and credit can be obtained for participation. The travel tours are not an UTB of N. [Treasury Regulation Section 1.513-7(a) Example 2].
Another example is a Section 501(c)(3) organization whose exempt purpose is to educate and foster culture unity among Americans of X descent about their country of origin. The organization sponsors two different travel tours. Travel Tour A involves trips that are designed to immerse participants in the history, culture, and language of country X. Substantially all of the daily itinerary for this tour includes scheduled instruction and visits to destinations selected because of their historical or cultural significance. Travel Tour B, however, offers the opportunity for participants to take guided tours to various locations in country X. Other than the optional guided tours, no instruction is offered on Travel Tour B. Destinations of principally recreational interest, rather than historical interest, are included on the Travel Tour B. Based on the facts and circumstances Travel Tour A is an activity that is substantially related to the organization’s exempt purpose. Travel Tour B, however, is an UTB of the organization. [Treasury Regulation Section 1.513-7(a) Example 4].

C. WHEN IS AN UTB REGULARLY CARRIED ON?

Even if a Section 501(c)(3) organization has income from a trade or business that is an UTB, the income will not be UBTI unless the UTB is regularly carried on by the Section 501(c)(3) organization. In determining whether an UTB is regularly carried on consideration is given to both the frequency and continuity with which the activities are conducted. [Treasury Regulation Section 1.513-1(c)(1)]. As a general rule, if the UTB is carried on with the same frequency and continuity as that of a comparable commercial business, then the UTB would be considered to be regularly carried on. Id. Conversely, if an UTB is of the type that would normally be carried on by a commercial enterprise on a year round basis, but is only carried on by the Section 501(c)(3) organization over a period of a few weeks, then the UTB is not conducted on a regular basis. [Treasury Regulation Section 1.513-1(c)(2)(i)]. For instance, the operation of a sandwich stand by a Section 501(c)(3) organization for two weeks at the state fair would not be the regular conduct of a trade or business. Id. However, the conduct of a year round business for one day each week would constitute the regular conduct of a trade or business. Id. Thus, while the operation of a sandwich stand for a few weeks is not the regularly carrying on
of a business, the operation of the same sandwich shop one day a week would be the regular conduct of a trade or business. *Id.*

If the activity undertaken is one that is undertaken by a commercial enterprise on a seasonal basis, the conduct of that activity by a Section 501(c)(3) organization for a substantial portion of the season would be the regular conduct of a trade or business. *Id.*

As to the intermittent carrying on of a business activity by a Section 501(c)(3) organization, the test is whether the conduct of the activities by the organization are similar to those of a commercial enterprise carrying on the same activity. [Treasury Regulation Section 1.513-1(c)(2)(ii)]. For instance, the publication of advertisements in a program for a sporting or theatrical event produced by a Section 501(c)(3) organization will not ordinarily be considered the regularly carrying on of a business. *Id.* One case of interest that involved the publication of advertisements for a sporting event is *NCAA v. Commissioner*, 914 F.2d 1417 (10th Cir1990). This case involved the advertising revenue received by the NCAA for advertisements in the programs produced for the NCAA basketball championship games (“March Madness”). The NCAA conceded that the advertising in the programs constituted a trade or business and that the trade or business was unrelated to the NCAA’s tax-exempt purpose. However, the NCAA’s position was that the advertising in the programs for March Madness did not constitute a trade or business that was being conducted on a regular basis. The IRS’ position was that in determining whether the activity was regularly carried on consideration had to be given to the preliminary time spent to solicit advertisements and prepare them for publication. The Tenth Circuit Court of Appeals rejected the IRS’ argument and stated that the relevant time to be considered was the duration of the tournament. As the tournament only spanned a few weeks, the Tenth Circuit Court of Appeals held that the advertising income, while income from an UTB, was not from a trade or business that was regularly carried on; and therefore the advertising revenue did not generate UBTI.

Additionally, where an organization sells certain types of goods or services to a particular class of persons in furtherance of its exempt functions or primarily for the convenience of such persons, the carrying on of the business will not be considered
regular. *Id.* An example of this would be the sale of textbooks by a college bookstore. *Id.*

There is a special rule for the infrequent conduct of a trade or business. Included in this category is the income producing or fundraising activities lasting only a short period of time. [Treasury Regulation Section 1.513-1(c)(2)(iii)]. Additionally, such activities will not be regarded as regularly carried on merely because they are conducted on an annual basis. [Treasury Regulation Section 1.513-1(c)(2)(iii)].

Thus, as with the test as to whether the trade or business has a causal relationship to the organization’s tax-exempt purpose the “regularly carried on” test is really a facts and circumstances test. In such circumstances, guidance can be gained from reviewing other factual situations that have been decided by the courts or on which the IRS has issued revenue rulings. As discussed above, a travel tour program sponsored by the alumni association of a university is an UTB if the travel tours are not educational. Although the offering of the travel tours are an UTB, the monies received from sponsoring the tours will not give rise to UTBI unless they are regularly offered. In Revenue Ruling 78-43, 1978-1 C.B. 164, the IRS ruled that the offering of ten travel tours a year constituted the regularly carrying on of a trade or business.

**D. WHAT ARE THE MODIFICATIONS THAT ARE ALLOWED TO BE MADE TO UBTI?**

Section 512(b) provides that certain types of income shall be excluded when determining an organization’s UBTI. Section 512(b)(1) provides that dividends, interest, loan payments, and annuity payments shall be excluded from UTBI. Section 512(b)(2) provides that royalty payments including overriding royalties shall be excluded from UBTI. Of particular note in the royalty area is the affinity credit card program. This is a program offered by financial institutions that offer credit cards. The financial institution will enter into an agreement with a tax-exempt organization, often a university, whereby the financial institution will offer to donors or supporters of the tax-exempt organization a credit card that will have a picture or some other logo associated with the organization on the front of the card. The financial organization obtains the list of supporters, or
alumni in the case of a university, from the tax-exempt organization. In exchange for providing the list of supporters or alumni, the financial institution agrees to pay to the tax-exempt entity a flat fee for each new card issued to a supporter or for a renewal by a supporter and a percent of the supporter’s purchases. In *Alumni Association of the University of Oregon, Inc. v. Commissioner*, 1996-63 T.C.M., the IRS claimed that the affinity card payments received by the Alumni Association were UBTI. The Tax Court, however, held that the payments were royalty payments and thus exempt from being treated as UBTI.

Section 512(b)(3)(A) provides the general rule that UBTI does not include rents received from real property and rents received from personal property leased with such real property, if the rents attributable to the personal property are an incidental amount of the total amounts received or accrued under the lease. Section 512(b)(3)(B), however, provides that if more than fifty percent (50%) of the total rent received or accrued under the lease is attributable to personal property, then the rents are not excluded from UBTI. Additionally, Section 513(b)(3)(B) provides that if the determination of the amount of the rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales), the rents are not excluded from UBTI.

The Treasury Regulations provide some examples that illustrate the effect the rental of personal property in conjunction with the rental of real property may have on the exclusion of the rental payments from UBTI. Treasury Regulation Section 1.512-1(c)(4) Example 1 provides the example of an exempt organization executing two leases. One lease is for the rental of office space. The annual rent for the office space is $7,250. The second lease is for the rental of a computer to be used in the leased office space. The annual rent for the lease of the computer is $750. Thus, the total rental payments under both leases is $8,000. At the time the computer is placed in service, though, it is determined that notwithstanding the terms of the leases, $3,000 or 37.5% percent ($3,000/$8,000) of the rent is actually attributable to the computer. Therefore, only the $5,000 attributable to the rental of the office space is excluded from the exempt
organization’s computation of UBTI under Section 512(b)(3). The $3,000 attributable to the rental of the computer, however, is not excluded, as the rental of the computer is not an “incidental amount of the total rents received.”

Treasury Regulation Section 1.512-1(c)(5) further provides that for the purpose of deciding whether a payment is for the rental of real property, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant are not rent from real property. Thus, the renting of a hotel room where maid services are provided for the convenience of the occupant would not constitute the rental of real property for purposes of Section 512(b) of the Code. Id. However, the renting of office space in an office building where the service provided was the cleaning of the entrance, lobby, and stairwell would not be considered services provided for the convenience of a particular occupant. Thus, the payments paid by the person leasing a particular office would constitute rent from the rental of real property. Id.

Another area where the IRS has ruled that payments were received for the use of space where services were provided instead of rental payments was the use of sports facilities owned by universities. In Rev. Rul. 80-298, 1980-2 C.B. 196, a university for a fixed fee allowed a professional football team to use the university’s stadium several months during the year. The agreement between the university and the professional football team provided that the university would be responsible for providing light and water and maintaining the playing surface. The university was also responsible for providing a dressing room, linen and stadium security services. The IRS ruled that by leasing the stadium in this manner, the university was providing services for the production of income and that the activity constituted a trade or business. Additionally, since the term of the lease was for several months, the trade or business was being carried on a regular basis. Additionally, the IRS ruled that the leasing to the professional team was not in furtherance of the university’s tax-exempt purpose. The IRS further ruled that as extensive services were being provided under the lease, the exemption for rental income did not apply. Thus, the IRS ruled that the university had UBTI.
In Rev. Rul. 80-297, 1980-2 C.B. 196, the IRS analyzed two situations involving income related to university owned tennis courts. In Situation 1 the university, during a ten week period in the summer, operated a tennis club. For a fee, the general public was invited to join the club and use the tennis courts and dressing rooms. Two university employees ran the club, collected fees and scheduled court time. In Situation 2, the university leased the facilities to an unrelated individual for a fixed fee for ten weeks. The individual formed a tennis club and hired employees to administer the affairs of the club. Under a contract with the university the individual was required to repair any damage to the facilities beyond normal wear and tear at the end of the ten weeks. In both Situation 1 and Situation 2 the IRS ruled that the university was engaged in an UTB. The IRS ruled, though, that in Situation 2 since the university was only leasing the premises and was not providing any services, the income received from the UTB was not treated as UBTI by virtue of the exception for rent. However, as to Situation 1, where services were provided, the rental exception did not apply and the fees received from the members constituted UBTI.

Another modification to UBTI are the gains or losses received by a Section 501(c)(3) organization from the sale, exchange, or other disposition of property, other than inventory or property sold to customers in the ordinary course of the trade or business. [Section 512(b)(5) of the Code].

E. **ARE THERE MODIFICATIONS TO THE MODIFICATIONS?**

1. **The General Rule**

The modifications to UBTI discussed above in III.C. will not apply to income attributable to debt financed property. [Section 512(b)(4) of the Code]. Debt financed property is any property which is held to produce income and with respect to which there is an acquisition indebtedness at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness during the 12-month period ending with the date of such disposition). [Section 514(b)(1) of the Code]. Acquisition indebtedness means the unpaid amount of the indebtedness incurred by the organization in acquiring or improving such property.
[Section 514(c)(1)(A) of the Code]. Acquisition indebtedness also includes indebtedness incurred before or after the acquisition or improvement of property, if such indebtedness would not have been incurred but for the acquisition or improvement of the property. [Sections 514(c)(1)(B) and 514(c)(1)(C) of the Code]. For example, if a Section 501(c)(3) organization pledges some of its investments as security for a loan, and then uses the proceeds from that loan to buy an office building that will be rented to the general public, the outstanding indebtedness with respect to the loan constitutes acquisition indebtedness. [Treasury Regulation Section 1.514(c)-1(a)(2) Example (1)].

If property is debt financed, the amount of income that is treated as UBTI is that amount which is the same percentage of the total gross income derived during the taxable year with respect to the property as (i) the average acquisition indebtedness for the taxable year is with respect to (ii) the average amount of the adjusted basis of such property during the period it is held by the organization during the taxable year. [Section 514(a) of the Code]. “Average acquisition indebtedness” for any taxable year is the average amount of the outstanding principal indebtedness during the portion of the taxable year the property is held by the organization. [Treasury Regulation Section 1.514-1(a)(3)(i)]. The average acquisition indebtedness is calculated by determining the amount of the outstanding principal indebtedness on the first day of each calendar month during the taxable year that the organization holds the property, adding the outstanding balances together, and dividing that sum by the total number of months the organization held the property. A fraction of a month shall be treated as a whole month. [Section 1.514-1(a)(3)(ii)]. Thus, if an organization buys a building on July 20, Year 1, and holds the building for the rest of Year 1, and if the outstanding principal indebtedness on the following dates were as follows: July 20-$300,000; August 1-$280,000; September 1-$260,000; October 1-$240,000; November 1-$220,000; and December 1-$200,000; the average acquisition indebtedness for Year 1 would be $250,000 (($300,000+$280,000+$260,000+$240,000+$220,000+$200,000)/6). [Treasury Regulation Section 1.514-1(a)(3)(iii) Example (1)].
“Average adjusted basis” is the average of (i) the adjusted basis of the property on the first day during the taxable year that the organization owns the property and (ii) the adjusted basis of the property on the last day of the taxable year that the organization owns the property. [Treasury Regulation Section 1.514-1(a)(2)]. Thus, if an organization buys a building on July 20, Year 1, for $510,000 using $300,000 of borrowed funds, and if on December 31, Year 1, after depreciation, the adjusted basis of the property is $490,000, the average adjusted basis of the building would be $500,000 (($510,000+$490,000)/2). [Treasury Regulation Section 1.514(a)-1(a)(2)(iv)].

Thus, if the average acquisition indebtedness is $250,000 and the average adjusted basis is $500,000, then fifty percent (50%) of the income from the property would be attributable to debt financed property for the year and would be UBTI.

The organization is allowed to reduce UBTI generated by the debt financed property by a percentage of the deductible expenditures that are directly related to the debt financed property. [Sections 514(a)(2) and 514(a)(3) of the Code]. The percent of the deductions that is allowed is the same percentage that is used in determining the amount of income to be included as UBTI. [Section 514(a)(2) of the Code]. If the property acquired is subject to depreciation, then for purposes of calculating the related deduction, only straight line depreciation shall be used. [Section 514(a)(3) of the Code].

For example, assume that in Year 1, Y, an exempt organization, receives $20,000 in rental income from a debt financed building Y owns. In Year 1, the expenditures that are directly related to the building are the following: property taxes - $5,000; interest on indebtedness - $5,000; and salary of building manager $15,000. Also assume that the ratio of the average acquisition indebtedness for the year to the average adjusted basis is fifty percent (50%). Y’s UBTI would be $10,000 (50% of $20,000). The deductions Y would be allowed to take to offset the UBTI would be $12,500 (($5,000+$5,000+$15,000) x 50%).
2. **Exceptions to the Debt Financed Property Rule**

   a. **Property Used in Furtherance of Exempt Purpose**

   Debt financed property does not include property, if substantially all of the use of the property is substantially related to the organization’s tax-exempt purposes. [Section 514(b)(1)(A) of the Code]. For purposes of determining substantial relationship, the rules that apply under Treasury Regulation Section 1.513-1 for determining if a trade or business is substantially related apply. [Treasury Regulation Section 1.514(b)-1(b)(1)(i)].

   As a general rule, if the property is used at least eighty-five percent (85%) of the time to further the organization’s exempt purpose, the property will be considered to be substantially used in furtherance of the organization’s exempt purpose. [Treasury Regulation Section 1.514(b)-1(b)(1)(ii)]. The determination of the extent to which a property is used for a particular purpose is based on all of the facts and circumstances. *Id.* The facts and circumstances to be taken into account are (i) the comparison of the time the property is used in furtherance of the exempt purpose with the total time the property is used; and (ii) a comparison of the portion of the property that is used in furtherance of the exempt purpose with the portion of the property that is used for all purposes. *Id.*

   To illustrate the above exception, assume a Section 501(c)(3) organization buys a small theater with respect to which there is an outstanding principal indebtedness. The organization uses the theater in furtherance of its exempt purposes. The organization also rents the theater to for profit entities about ten percent (10%) of the time. In this situation, the organization’s use of the theater is substantially related to the use of its exempt purpose. Therefore, no portion of the property is treated as debt financed.

   On the other hand, assume the Section 501(c)(3) organization buys a building with a theater. The organization obtains a mortgage to buy the building. The theater occupies half of the building. The organization rents out the other half of the building to for profit tenants. The rents received would be considered UBTI as they would be
attributable to debt financed property that was not being used in substantial furtherance of the organization’s exempt purpose.

b. **Property Used in Exempted Trades or Businesses**

Debt finance property also does not include property to the extent that it is used in any of the following trades or businesses that have been statutorily determined not to be UTBs: (i) a trade or business in which substantially all the work is performed for the 501(c)(3) organization without compensation; (ii) a trade or business which is carried on by the organization primarily for the convenience of its members, students, patients, officers or employees; or (iii) a trade or business which involves the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions. [Section 514 (b)(1)(D)].

c. **Property Acquired in the Same Neighborhood**

Also excluded from the term debt financed property is real property that is acquired by a Section 501(c)(3) organization for the principal purpose of using the land within ten years of the purchase date for a purpose that is in furtherance of the organization’s exempt purpose, and that is in the same neighborhood as other property owned by the organization, and that is being used in such manner, [Section 514(b)(3)(A) of the Code]. This exception shall apply even if there is a structure on the property, provided the intended future use of the property requires the demolition or removal of the structure. [Section 514(b)(b)(3)(C)(i)]. For purposes of this exception, “neighborhood” generally means that the land is contiguous to property currently owned by the organization. [Treasury Regulation Section 1.514(b)-1(d)(ii)]. For purposes of this rule, contiguous includes property that would be contiguous but for the fact of a road, street, railroad, stream, or similar property. *Id.* A parcel may be in the neighborhood even if it is not contiguous but it is within one mile of property owned by the organization, if based on the particular facts and circumstance the purchase of contiguous land is unreasonable. *Id.* An example of a parcel of land being considered as being in the neighborhood but not contiguous is if the owners of the adjacent land either refuse to sell or are asking
unreasonable prices, and the land to be purchased is within one block of the organization’s current property. **Id.**

An example of the above exception would be the purchase of an apartment building by a private university that is a Section 501(c)(3) organization. The university obtains a loan to complete the purchase. The university intends to demolish the apartment building within the next ten years and build a new classroom building. During the first four years that the university owns the building, the university continues to collect rent. In year five, the university abandons the idea of building a new classroom building and sells the property. If the property is still subject to acquisition indebtedness at the time of the sale, the sale proceeds would be treated as income from debt financed property, and would be UBTI. In this case, even though the University’s intent changed in year five, the rent received in the first four years still qualifies for the exception to the debt financed rules. [Treasury Regulation Section 1.514(b)-1(d)(3)(i)(b) Example 1].

Even though the neighborhood rule applies for ten years, in order to not have the income from the property not be treated as income from debt financed property for years after the fifth year, the organization must establish to the satisfaction of the Commissioner of the IRS that the future use of the property in furtherance of the organization’s purpose will indeed occur before the expiration of the ten year period. The way an organization would satisfy this requirement would be by receiving a favorable ruling from the Commissioner as to this fact. The request for such a ruling must be made at least ninety (90) days before the end of the fifth year following the acquisition of the property. [Treasury Regulation Section 1.514(b)-1(d)(1)(iii)].

If an exempt organization originally buys a parcel of contiguous improved real property with the intent of demolishing the improvement, and using the property in furtherance of its exempt purpose, and before the ten year period expires decides to use the building on the property, the exception would no longer apply as of the date the organization abandoned its intent to demolish the building. [Treasury Regulation Section 1.514-1(d)(3)(i)(b) Example 4].
d. **Property Acquired by Gift, Devise, or Bequest**

Property that is acquired by gift, devise, or bequest that is subject to a mortgage will not be treated as debt financed property for the first ten years following the date of the acquisition, provided certain requirements are satisfied. [Section 514(c)(2)(B) of the Code]. As to the receipt of a gift of real property, the exception will not apply if the mortgage was placed on the property within the five year period preceding the date of the gift, or if the donor did not own the property for at least five years prior to the date of the gift. *Id.* The five year rule does not apply to inherited property. Additionally, in order for the exception to apply, the exempt organization may not either (i) assume or agree to pay the mortgage, or (ii) make any payment for the equity owned in the property by the donor or the decedent. *Id.*

Thus, assume on January 1, Year 1, T dies. Under the terms of T’s will, X, a Section 501(c)(3) organization is to receive an office building owned by T. The office building is subject to a mortgage. X does not assume the mortgage. For the ten year period following X’s receipt of the property, the rental income received by X is not income from debt finance property. If in Year 3, however, X agrees to assume the mortgage, the rental income received after X assumes the mortgage would be income from debt financed property. [Treasury Regulation Section 1.514(c)-1(b)(3)(iv) Examples (1) and (2)].

**IV. HOW AND WHEN IS UBTI REPORTED AND PAID?**

If after applying the above rules a determination is made that the Section 501(c)(3) organization has UBTI of $1,000 or more, the organization must file a Form 990-T. [Treasury Regulation Section 1.6012-1(e)]. The filing of the Form 990-T is in addition to the other returns the organization must file. *Id.* The return must be filed by the fifteenth (15th) day of the fifth (5th) month following the end of the organization’s tax year. [Section 6072(e) of the Code]. As a practical matter, if the organization’s tax year is the calendar year, the Form 990-T would be due by the May 15 following the close of
the organization’s tax year. All Forms 990-T are filed with the Internal Revenue Service Center in Ogden, Utah 84201-0027. [2010 Instructions for Form 990-T, page 3].

Additionally, if a Section 501(c)(3) organization has UBTI, the organization may also be required to file and pay estimated taxes. If the organization is a trust, the organization will not be required to file estimated taxes. [Section 6654(l)(3) of the Code]. If the organization, however, is a corporation and has UBTI, the corporation will be required to file estimated taxes if the taxes due for the year exceed $500. [Section 6655(f) of the Code]. The estimated tax payments are due on April 15, June 15, September 15, and December 15. The amount of each estimated tax payment shall be an amount that is equal to the lesser of (i) twenty-five percent (25%) of the tax liability for the corporation for the prior tax year; or (ii) twenty-five percent (25%) of the tax liability for the corporation for the current year. [Section 6655(d)(1) of the Code].

V. UBTI - EFFECT ON TAX EXEMPT STATUS

Treasury Regulation Section 1.501(c)(3)-1(e)(1) provides as follows:

An organization may meet the requirements of Section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in Section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

In 1971 General Counsel Memorandum 34682, the IRS answered the question how much trade or business may an organization engage in under the limitations of the “primary purpose” provision of Treasury Regulation Section 1.501(c)(3)-1(e) without defeating qualification for charitable status under Section 501(c)(3). The answer that the IRS gave to this question was as follows:

aside from express statutory limitations on business activity, such as Section 502 and the newly enacted provisions relating to private foundations there is no quantitative limitation on the “amount” of
unrelated business an organization may engage in under Section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated.

Section 502(a) of the Code provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under Section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under Section 501. Section 502, however, does not apply to any business if the work provided for the business is performed without compensation. [Section 502(b)(2)].

In Technical Advice Memorandum ("TAM") 9521004, a Section 501(c)(3) organization that qualified as a public charity under Section 509(a)(2) of the Code operated a travel agency. Approximately one-half (1/2) of the organization’s gross receipts for a three year period was derived from the operation of the travel agency. The exempt purpose of the organization was to advance the good and welfare of various shelters and institutions which have as their purpose the care, support, maintenance and education of children. The IRS in this TAM ruled that the operation of the travel agency did not affect the exempt status of the organization. The IRS did rule, though, that the income received from the travel agency represented income from an UTB, and was subject to Sections 511 through 514 of the Code. In announcing these rulings, the IRS stated as follows:

X’s exemption is not jeopardized merely because it conducts an unrelated business as a substantial part of its total activities, as Section 1.501(c)(3)-1(e)(1) of the regulations indicates. The key issues are the reason why the business is carried on and the organization’s primary purpose. A purpose to raise funds to support the organization’s exempt function is a legitimate reason for an organization to conduct a business, although it would have to pay tax on any unrelated business taxable income derived from a business not otherwise substantially related to its performance or its exempt purposes. As long as the conduct of such business is not the organization’s primary purpose, as determined by the facts and circumstances, the organization may conduct such business consistent with Section 501(c)(3).
The IRS did point out that although the travel agency revenue represented a substantial portion of the organization’s gross receipts, the travel agency generated little profit. Also, the IRS noted that the greater part of total employee time was devoted to the exempt purpose of the organization. Additionally, the IRS noted that hundreds of volunteers devoted time to the exempt purpose of the organization, and that the total collective time devoted to the exempt purpose outweighed the time devoted to the travel agency.

In Technical Advice Memorandum 200021056, a Section 501(c)(3) organization that qualified as a public charity under Section 509(a)(1) of the Code operated a tea room, a consignment shop, and a gift shop. The organization trained the consignors to make handcrafted clothes and toys for children. The gift shop sold items that were purchased by the organization’s membership from for profit vendors for resale in the gift shop. The exempt purpose of the organization was to assist needy and deserving women in their efforts to earn an honest livelihood by their own industry. Thirty-four percent (34%) of the organization’s total revenue was generated from the operation of the tea room. Thirty-three percent (33%) of the organization’s revenue came from the consignment shop, and twenty-eight percent (28%) of the organization’s revenue came from the gift shop. The IRS ruled that the operation of the tea room and gift shop did not represent a substantial non-exempt purpose, and thus the operation of these two activities did not affect the organization’s exempt status. The IRS did rule, though, that the income earned by the tea room and the gift shop was UBTI.

As discussed above, though, if the IRS determines that the UTB is the organization’s primary purpose, the organization’s tax-exempt status will be revoked. [See PLR 201108048].

VI. CONCLUSION

Thus, as long as a tax-exempt organization’s primary purpose is the furtherance of its tax-exempt purpose, the carrying on of a trade or business for the purpose of raising revenue to further the tax-exempt purpose is permissible. However, as discussed above the revenue from the trade or business may be subject to income taxes. Due to the
complexity of the rules relating to UBTI, though, it is advisable that any tax-exempt organization that is contemplating on raising revenue through any means other than a pure solicitation for a charitable donation obtain advice as to the tax treatment of the revenue to be raised.