

THE CALIFORNIA STATE UNIVERSITY
Office of the Chancellor
401 Golden Shore Drive
Long Beach, California 90802-4210
(562) 951-4610

Due Date: January 10, 2003

Date: November 19, 2002 **Code:** AD 02-02

To: Campus Tax Coordinators

From: Sean Boylan
Acting Director
Systemwide Financial Operations

Subject: **Unrelated Business Income Tax Worksheet**

Attached is the Unrelated Business Income Tax Worksheet. The worksheet is to be completed by the campus and returned to the Chancellor's Office to facilitate the preparation and filing of the systemwide Form 990-T tax return. Also attached is information that may be used to assist the campus in completing the worksheet, including:

- Depreciation Worksheet
- Prior Years Depreciation Schedule
- Campus Tax Coordinator Roster
- Prior Year Taxable Income Listing
- Prior Years Tax Worksheet
- Suggested Income Tax References
- 2001 Instructions for Form 990-T
- IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations (Rev. March 2000)

The Prior Years Tax Worksheet displays the tax liability or net operating loss carryforward from fiscal years 1995/96 through 2000/01 for each campus. Campuses with a tax liability will be billed for any net tax liability after the 2001/02 990-T has been completed.

If you have any questions, please contact Mark Osborne at (562) 951-4610 or e-mail mosborne@calstate.edu

Distribution: Presidents
Vice Presidents for Administration
Financial Managers
Accounting Officers
Mr. Dennis Hordyk
Mr. Richard P. West (without attachments)
Mr. Mark Osborne

UNRELATED BUSINESS INCOME TAX WORKSHEET
For the Year Ending June 30, 2002

Campus: _____

Instructions: Prepare this worksheet using the attached 2001 instructions for Form 990-T Exempt Organization Business Income Tax Return and the following information:

- All campuses are required to complete the UBIT worksheet. Campuses that do not have any reportable income must still complete PART V, sign, and submit the worksheet.
- The information provided by the campuses will be consolidated and used to prepare the CSU 990-T. As such, it is critical that all information be complete and accurate.
- The worksheet is to be prepared using fiscal 2001/02 data.
- All unrelated business income should be reported. The \$1,000 minimum taxable income threshold indicated in the instructions should be ignored.
- The worksheet contains only the parts of the 990-T that could be needed by a campus. Portions of the worksheet that are not applicable to your campus should be marked "n/a."
- Indirect expenses allocated must be directly related to the income.
- Assets used for the production of unrelated business income must be depreciated rather than directly expensed. Campuses depreciating assets must complete the Depreciation Schedule to provide the information necessary for the compilation of Form 4562, Depreciation and Amortization. The Prior Years Depreciation Schedule identifies assets previously depreciated on prior tax returns. Specific instructions are available in IRS Publication 946, How to Depreciate Property.
- Questions about preparing the worksheet can be referred to your campus counsel or the Chancellor's Office.

Submit worksheet and schedules no later than January 10, 2003 to:

The California State University
Office of the Chancellor
401 Golden Shore Drive, 5th Floor
Long Beach, CA 90802-4210
Attention: Associate Director, Tax & Legislation

Campus: _____

Unrelated Business Income Summary:

Campus should summarize unrelated business income by category (i.e., corporate sponsorships, film fees, stadium rentals, etc.)

Source:	Amount
_____	\$ _____
_____	_____
_____	_____
_____	_____
_____	_____
_____	_____
Total	\$ _____

PART I Unrelated Business Income		(A) Income	(B) Expenses	(C) Net
1a	Gross receipts or sales \$ _____			
b	Less returns and allowances \$ _____	1c		
2	Cost of goods sold (Schedule A, line 7)	2		
3	Gross profit (subtract line 2 from line 1c)	3		
4a	Capital gain net income (attach Schedule D)	4a		
b	Net gain (loss) (Form 4797, Part II, line 18) (attach Form 4797)	b		
c	Capital loss deduction for trusts	c		
5	Income (loss) from partnerships (attach statement)	5		
6	Rent Income (Schedule C)	6		
7	Unrelated debt-financed income (Schedule E)	7		
8	Interest, annuities, royalties, and rents from controlled organizations (see page 7 of instructions)	8		
10	Exploited exempt activity income (Schedule I)	10		
11	Advertising Income (Schedule J)	11		
12	Other income (see page 8 of instructions-attach schedule)	12		
13	TOTAL (combine lines 3 through 12)	13		

SCHEDULE A- COST OF GOODS SOLD			
Method of inventory valuation: Lower of cost or market			
1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of Labor	3	
4a	Additional section 263A costs (attach schedule)	4a	
b	Other costs (attach schedule)	b	
5	TOTAL-Add lines 1 through 4b	5	
6	Inventory at end of year	6	
7	Cost of goods sold. Subtract line 6 from line 5. (enter here and on line 2, Part I)	7	
8	Do the rules of section 263A (with respect to property produced or acquired for resale) apply to the organization? <input type="checkbox"/> Yes <input type="checkbox"/> No		

PART II Deductions Not Taken Elsewhere (See page 8 of the instructions for limitations on deductions.) (Except for contributions, deductions must be directly connected with the unrelated business income.)			
14	Compensation of officers, directors, and trustees (Schedule K)	14	
15	Salaries and wages	15	
16	Repairs and maintenance	16	
17	Bad debts	17	
18	Interest (attach schedule)	18	
19	Taxes and licenses	19	
20	Charitable contributions (see page 10 of instructions for limitation rules)	20	
21	Depreciation (attach Form 4562)	21	_____
22	Less depreciation claimed on Schedule A or elsewhere on return	22a	_____
23	Depletion	23	
24	Contributions to deferred compensation plans	24	
25	Employee benefit programs	25	
26	Excess exempt expenses (Schedule I)	26	
27	Excess readership costs (Schedule J)	27	
28	Other deductions (attach schedule)	28	
29	TOTAL DEDUCTIONS (add lines 14 through 28)	29	
30	Unrelated business taxable income before net operating loss deduction (subtract line 29 from line 13)	30	
31	Net operating loss deduction (from Prior Years Tax Worksheet)	31	
32	Unrelated business taxable income (subtract line 31 from line 30)	32	

PART IV Tax and Payments			
39a	Foreign tax credit (corporations attach Form 1118; trusts attach Form 1116)		
b	Other credits (see page 13 of the instructions)		
c	General business credit. Check if from: <input type="checkbox"/> Form 3800 <input type="checkbox"/> Form (specify) > _____		

PART V Statements Regarding Certain Activities and Other Information (see instructions on page 11)		Yes	No
1	At any time during the 1998 calendar year, did the organization have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? If "Yes," enter the name of the foreign country here. > _____		
2	During the tax year, did the organization receive a distribution from, or was it the grantor of, or transfer to a foreign trust? If "Yes," see page 14 of the instructions for other forms the organization may be required to file.		
3	Enter the amount of tax-exempt interest received or accrued during the tax year. > \$ _____		

Under penalties of perjury, I declare that I have examined this worksheet, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of Campus President

Date

Schedule C—Rent Income (From Real Property and Personal Property Leased With Real Property)

(See instructions on page 16.)

1 Description of property

(1)			
(2)			
(3)			
(4)			
2 Rent received or accrued		3 Deductions directly connected with the income in columns 2(a) and 2(b) (attach schedule)	
(a) From personal property (if the percentage of rent for personal property is more than 10% but not more than 50%)	(b) From real and personal property (if the percentage of rent for personal property exceeds 50% or if the rent is based on profit or income)		
(1)			
(2)			
(3)			
(4)			
Total		Total	Total deductions. Enter here and on line 6, column (B), Part I, page 1. ▶
Total income (Add totals of columns 2(a) and 2(b). Enter here and on line 6, column (A), Part I, page 1.) ▶			

Schedule E—Unrelated Debt-Financed Income (See instructions on page 17.)

1 Description of debt-financed property		2 Gross income from or allocable to debt-financed property	3 Deductions directly connected with or allocable to debt-financed property	
			(a) Straight line depreciation (attach schedule)	(b) Other deductions (attach schedule)
(1)				
(2)				
(3)				
(4)				
4 Amount of average acquisition debt on or allocable to debt-financed property (attach schedule)	5 Average adjusted basis of or allocable to debt-financed property (attach schedule)	6 Column 4 divided by column 5	7 Gross income reportable (column 2 × column 6)	8 Allocable deductions (column 6 × total of columns 3(a) and 3(b))
(1)		%		
(2)		%		
(3)		%		
(4)		%		
			Enter here and on line 7, column (A), Part I, page 1.	Enter here and on line 7, column (B), Part I, page 1.

Totals ▶

Total dividends-received deductions included in column 8 ▶

Schedule F—Interest, Annuities, Royalties, and Rents From Controlled Organizations (See instructions on page 18.)

1 Name of Controlled Organization	2 Employer Identification Number	Exempt Controlled Organizations			
		3 Net unrelated income (loss) (see instructions)	4 Total of specified payments made	5 Part of column (4) that is included in the controlling organization's gross income	6 Deductions directly connected with income in column (5)
(1)					
(2)					
(3)					
(4)					

Nonexempt Controlled Organizations

7 Taxable Income	8 Net unrelated income (loss) (see instructions)	9 Total of specified payments made	10 Part of column (9) that is included in the controlling organization's gross income	11 Deductions directly connected with income in column (10)
(1)				
(2)				
(3)				
(4)				
			Add columns 5 and 10. Enter here and on line 8, Column (A), Part I, page 1.	Add columns 6 and 11. Enter here and on line 8, Column (B), Part I, page 1.

12 Totals

Schedule G—Investment Income of a Section 501(c)(7), (9), or (17) Organization

(See instructions on page 18.)

1 Description of income	2 Amount of income	3 Deductions directly connected (attach schedule)	4 Set-asides (attach schedule)	5 Total deductions and set-asides (col. 3 plus col. 4)
(1)				
(2)				
(3)				
(4)				
Totals ▶	Enter here and on line 9, column (A), Part I, page 1.			Enter here and on line 9, column (B), Part I, page 1

Schedule I—Exploited Exempt Activity Income, Other Than Advertising Income

(See instructions on page 18.)

1 Description of exploited activity	2 Gross unrelated business income from trade or business	3 Expenses directly connected with production of unrelated business income	4 Net income (loss) from unrelated trade or business (column 2 minus column 3). If a gain, compute cols. 5 through 7.	5 Gross income from activity that is not unrelated business income	6 Expenses attributable to column 5	7 Excess exempt expenses (column 6 minus column 5, but not more than column 4).
(1)						
(2)						
(3)						
(4)						
Column totals ▶	Enter here and on line 10, col. (A), Part I, page 1.	Enter here and on line 10, col. (B), Part I, page 1.				Enter here and on line 26, Part II, page 1.

Schedule J—Advertising Income (See instructions on page 19.)

Part I Income From Periodicals Reported on a Consolidated Basis

1 Name of periodical	2 Gross advertising income	3 Direct advertising costs	4 Advertising gain or (loss) (col. 2 minus col. 3). If a gain, compute cols. 5 through 7.	5 Circulation income	6 Readership costs	7 Excess readership costs (column 6 minus column 5, but not more than column 4).
(1)						
(2)						
(3)						
(4)						
Column totals (carry to Part II, line (5)) ▶						

Part II Income From Periodicals Reported on a Separate Basis (For each periodical listed in Part II, fill in columns 2 through 7 on a line-by-line basis.)

(1)						
(2)						
(3)						
(4)						
(5) Totals from Part I						
Column totals, Part II ▶	Enter here and on line 11, col. (A), Part I, page 1.	Enter here and on line 11, col. (B), Part I, page 1.				Enter here and on line 27, Part II, page 1.

Schedule K—Compensation of Officers, Directors, and Trustees (See instructions on page 19.)

1 Name	2 Title	3 Percent of time devoted to business	4 Compensation attributable to unrelated business
		%	
		%	
		%	
		%	
Total —Enter here and on line 14, Part II, page 1 ▶			

Depreciation Worksheet

The worksheet should report all assets placed into service during the tax year. Additional sheets may be used if more columns are required. Refer to instructions for Form 4562, Publication 946, campus records, and information contained on the Prior Years Depreciation Schedule for guidance.

	Asset 1	Asset 2	Asset 3	Asset 4	Total
Description of Property (include state tag # where applicable)					
MACRS/Other/Listed					
Classification of Property					
Mo/Yr in Service					
Cost					
Business Use Percentage					
Sec 179 Deduction					
Basis for Depreciation					
Residual Value					
Recovery Period					
Convention					
Method					
Depreciation Schedule:					
1997/98					(a)
1998/99					(b)
1999/00					(c)
2000/01					(d)
2001/02					
2002/03					
2003/04					
2004/05					
2005/06					
2006/07					
2007/08					
Thereafter					
Total Additions					
1995/96 from Prior Years Depreciation Schedule (e)					
1996/97 from Prior Years Depreciation Schedule (f)					
Total depreciation expense for 2001/02 (a)+(b)+(c)+(d)+(e)+(f)					
Depreciation expense shown on line 21					
Depreciation expense shown on line 22					
Total depreciation expense for 2001/02					

Prior Years Depreciation Schedule

Campus	Description of Property	MACRS/Other /Listed	Classification of Property	Mo/Yr in Service	Cost	Business Use Percentage	Sec 179 Deduction	Basis for Depreciation	Residual Value	Recovery Period	Convention	Method
Totals												
<u>FY 95/6</u>												
FU	Stadium Scoreboard	MACRS	10 year	Aug-88	230,600	100%	-	230,600	-	10	HY	S/L
FU	Baseball Scoreboard	MACRS	11 year	Feb-89	223,700	100%	-	223,700	-	10	HY	S/L
FU	Freeway Sign	MACRS	12 year	Mar-89	127,362	100%	-	127,362	-	10	HY	S/L
ST	Computer equipment	MACRS	5 year	Aug-91	8,892	100%	-	8,892	-	5	HY	200DB
<u>FY 96/7</u>												
PO	Digital Voice Logging Recorder	MACRS	5 year	Sep-92	14,014	40.913%	-	5,734	-	5	HY	200DB
PO	Radio Dispatch Console	MACRS	5 year	May-93	16,549	40.913%	-	6,771	-	5	HY	200DB
FU	Sports Complex (note 2)	MACRS	39 Year	Feb-92	9,731,730	5.000%	-	486,587	-	39	MM	S/L
SM	Modems, Modem Cards, Power Sup	MACRS	5 year	Apr-93	8,934	100.000%	-	8,934	-	5	HY	200DB
SM	Data Storage Tapes	MACRS	5 year	May-93	1,015	100.000%	-	1,015	-	5	HY	200DB
SM	Access Server	MACRS	5 year	Jun-93	6,580	100.000%	-	6,580	-	5	HY	200DB
SM	Newsserver Software	MACRS	3 year	Nov-92	640	100.000%	-	640	-	3	HY	S/L
SM	ARS Server Software	MACRS	3 year	Sep-92	7,165	100.000%	-	7,165	-	3	HY	S/L
ST	Public Safety Vehicle (note 1)	MACRS	5 year	Dec-92	21,596	22.763%	-	4,916	228	5	HY	200DB
<u>FY 97/8</u>												
SM	Computer	MACRS	5 year	Sep-93	1,320	100.000%	-	1,320	-	3	HY	200DB
SM	Computer Software	MACRS	3 year	Jun-93	2,703	100.000%	-	2,703	-	5	HY	S/L
<u>FY 98/9</u>												
SM	Computer	MACRS	5 year	Aug-98	1,320	100.000%	-	1,320	-	5	HY	200DB
ST	Gas Carts	MACRS	5 year	Jul-98	26,580	100.000%	-	26,580	-	5	HY	200DB
ST	Portion of Vehicle	MACRS	3 year	Jul-98	9,214	100.000%	-	9,214	-	3	HY	200DB
<u>FY 99/0</u>												
SM	Computer	MACRS	5 year	Aug-99	1,320	100.000%	-	1,320	-	5	HY	200DB
SM	Network Catalyst	MACRS	5 year	Sep-99	7,207	100.000%	-	7,207	-	5	HY	200DB
<u>FY 00/01</u>												
ST	Carton Sealer	MACRS	5 year	Oct-02	9,976	100.000%	-	9,976	-	5	HY	200DB

Note 1: Not listed property since police vehicle: Reg. section 1.274-5T(k)

Note 2: Final depreciation will be \$8,822 in year 40

Prior Years Depreciation Schedule

Prior to 95/96	95/96	96/97	97/98	98/99	99/00	00/01	.01/02	.02/03	.03/04	.04/05	.05/06	.06/07	Thereafter	Total Depreciation
-	59,944	72,741	86,532	90,761	91,056	87,112	81,247	76,831	74,392	72,285	13,053	12,477		818,431
-	23,060	23,060	23,060	23,060	23,060	23,060	23,060	23,060	23,060	23,060				230,600
-	22,370	22,370	22,370	22,370	22,370	22,370	22,370	22,370	22,370	22,370				223,700
-	12,736	12,736	12,736	12,736	12,736	12,736	12,736	12,736	12,736	12,736				127,360
-	1,778	2,845	1,707	1,024	1,024	512								8,890
-	-	1,147	1,835	1,101	661	661	329							5,734
-	-	1,354	2,167	1,300	780	780	390							6,771
-	-	3,639	12,477	12,477	12,477	12,477	12,477	12,477	12,477	12,477	12,477	12,477	358,178	
-	-	1,787	2,859	1,715	1,029	1,029	515							8,934
-	-	203	325	195	117	117	58							1,015
-	-	1,316	2,106	1,263	758	758	379							6,580
-	-	107	214	214	105									640
-	-	1,194	2,388	2,388	1,195									7,165
-	-	983	1,573	944	566	566	56							4,688
-	-	-	264	422	253	152	152	77						1,320
-	-	-	451	901	901	450								2,703
				264	422	253	152	152	77					1,320
				5,316	8,506	5,103	3,062	3,062	1,541					26,590
				3,071	4,096	1,365	682							9,214
				264	422	253	152	152	77					1,320
				1,441	2,306	1,384	830	830	416					7,207
					1,995	3,192	1,915	1,149	1,149	576				9,976

Campus Tax Coordinators Roster

CAMPUS	CONTACT	PHONE	FAX	E-MAIL
Bakersfield	Suzanne Muller	(661) 664-2179	(805) 664-2134	smuller@csub.edu
Channel Islands	Art Flores	(805) 437-8423	(805) 437-8424	aflores@csuci.edu
Chico	George Wellman	(530) 898-5103	(916) 898-6974	gwellman@csuchico.edu
Dominguez Hills	Brian Dahm	(310) 243-3188	(310) 217-6963	bdahm@research.csudh.edu
Fresno	Steve Katz	(559) 278-6632	(559) 278-4398	skatz@csufresno.edu
Fullerton	Lydia Rodriguez	(714) 278-2511	(714) 449-5816	lrodriguez@fullerton.edu
Hayward	John Abbey	(510) 885-3642	(510) 885-4258	jabbey@csuhayward.edu
Humboldt	Donna Sorensen	(707) 826-3521	(707) 826-3334	dks2@humboldt.edu
Long Beach	Shawn McCown	(562) 985-7681	(562) 985-7573	smccown@csulb.edu
Los Angeles	Thomas Leung	(213) 343-3571	(213) 343-6437	tleung@cslanet.calstate.edu
Maritime Academy	Christy Redford	(707) 654-1025	(707) 654- 1001	credford@sum.edu
Monterey Bay	Ruth Stipp	(408) 582-3088	(408) 582-3399	rstipp@monterey.edu
Northridge	Robert Barker	(818) 677-2305	(818) 677-3845	robertbarker@csun.edu
Pomona	Brian Jenkins	(909) 869-3169	(909) 869-4223	bkjenkins@csupomona.edu
Sacramento	Kathi McCoy	(916) 278-7439	(916) 278-2209	mccoyk@skymail.csus.edu
San Bernardino	Sheryl Pytlak	(909) 880-5153	(909) 880-7604	Spytlak@wiley.csusb.edu
San Diego	Ellene Gibbs	(619) 594-5901	(619) 594-6022	egibbs@mail.sdsu.edu
San Francisco	Larry Ware	(415) 338-2599	(415) 338-2461	larryw@sfsu.edu
San Jose	Shawn Bibb	(408) 924-1663	(408) 924-1698	sbibb@sjsu.edu
San Luis Obispo	Lorlie Leetham	(805) 756-7417	(805) 756-2292	lleetham@calpoly.edu
San Marcos	Lam Le	(760) 750-4472	(760) 750-3156	lle@csusm.edu
Sonoma	Letitia Coate	(707) 664-2836	(707) 664-4000	letitia.coate@sonoma.edu
Stanislaus	Becka Paulsen	(209) 667-3379	(209) 667-7053	BPaulsen@csustan.edu
Chancellor's Office	Mark Osborne	(562) 951-4610	(562) 951-4865	mosborne@calstate.edu

Prior Year Taxable Income Listing

Campus	Description
Chico	Parking
Chico	Rental of athletic facility to professional team
Chico	Alumni placement
Chico	Services-professional baseball team
Fresno	Parking/printing/subscription fees
Fullerton	Rent-sports complex
Fullerton	Corporate advertising
Hayward	Rent
Humboldt	Public use of athletic facilities
Los Angeles	Use of facilities/alumni services
Northridge	Use of facilities
Pomona	Police dispatch services
Sacramento	Corporate sponsorship
Sacramento	Alumni placement
Sacramento	Use of facilities
San Diego	Corporate sponsorship
San Francisco	Newspaper advertising
San Francisco	Use of facilities
San Francisco	Newspaper advertising
San Luis Obispo	Parking
San Marcos	Off campus network
San Marcos	Use of facilities
Sonoma	Alumni placement
Stanislaus	Parking fine collections

Prior Year Tax Worksheet

	Net Income (Loss)						Total	Tax Liability	Tax Credit	NOL Carryfwd
	FY 95/96	FY96/97	FY97/98	FY98/99	FY 99/01	FY 00/01				
										(1)
Bakersfield										
Channel Island										
Chico	1,622	1,267	(539)	5,304	19,649	15,559	42,862	6,429		
Dominquez Hills										
Fresno			6,316	(5,422)	(17,518)	(23,812)	(40,436)		2,444	24,144
Fullerton	(56,988)	(16,004)	(11,482)	(10,772)	(74,471)	(67,712)	(237,429)		14,349	141,766
Hayward	37	(3,131)	(3,466)	(31,460)	(48,960)	(243,579)	(330,559)		19,978	197,373
Humboldt	(226)	(614)	(267)	(556)	(133)	(1,056)	(2,852)		172	1,703
Long Beach										
Los Angeles	2,217	(16,893)	(1,235)	1,390	24,780	(46,085)	(35,826)		2,165	21,391
Maritime Academy										
Monterey Bar										
Northridge				85,111	88,280	7,370	180,761	27,114		
Pomona	604	24,575	334	75	(176)	(598)	24,814	3,722		
Sacramento				(409)	(8,830)	(10,654)	(19,893)		1,202	11,878
San Diego						(37,469)	(37,469)		2,265	22,372
San Francisco	(27,030)	(18,724)	8,368	2,248	93,848	47,356	106,066	15,910		
San Jose	(14,819)	11,656					(3,163)		191	1,889
San Luis Obispo		306	252	(8,729)	(30,730)	(51,409)	(90,310)		5,458	53,923
San Marcos	576	10,569	(2,533)	(74,867)	(12,255)	1,180	(77,330)		4,674	46,173
Sonoma	(3,704)	(9,047)	(8,731)	(12,474)	(7,210)	(7,700)	(48,866)		2,953	29,177
Stanislaus	8,499	(44,053)	24,575	43,839	8,351	(23,370)	17,841	2,676		
Chancellor's Office										
Total	(89,212)	(60,093)	11,592	(6,722)	34,625	(441,979)	(551,789)	55,852	53,408	551,789

(1) Amount to be reported on Part II, line 31 of Unrelated Business Income Tax Worksheet.

Suggested Tax References

Internal Revenue Code

<http://www.fourmilab.ch/ustax/www/sections.html>

IRS Forms & Publications

<http://www.irs.gov/formspubs/index.html>

CSU UBIT Memo

AD 96-08, dated March 15, 1996

Unrelated Business Income Tax Information Package and Worksheets

UC UBIT Memo

<http://www.ucop.edu/ucophome/policies/bfb/a61.html>

Instructions for Form 990-T

Exempt Organization Business Income Tax Return

Section references are to the Internal Revenue Code unless otherwise noted.

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A Change To Note

If an exempt organization, which is required to file Form 990-T, wants to allow the IRS to discuss its 2001 Form 990-T with the paid preparer who signed it, check the "Yes" box in the area where the officer of the organization signed the return. See page 15.

Photographs of Missing Children

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

Unresolved Tax Issues

If the organization has attempted to deal with an IRS problem unsuccessfully, it should contact the Taxpayer Advocate. The Taxpayer Advocate independently represents the organization's interest and concerns within the IRS by protecting the rights and resolving problems that have not been fixed through normal channels.

While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that the organization's case is given a complete and impartial review.

The organization's assigned personal advocate will listen to its point of view and will work with the organization to address its concerns. The organization can expect the advocate to provide:

- A "fresh look" at a new or on-going problem.
- Timely acknowledgement.
- The name and telephone number of the individual assigned to its case.
- Updates on progress.
- Timeframes for action.
- Speedy resolution.
- Courteous service.

When contacting the Taxpayer Advocate, the organization should provide the following information:

- The organization's name, address, and employer identification number (EIN).
- The name and telephone number of an authorized contact person and the hours he or she can be reached.
- The type of tax return and years involved.
- A detailed description of the problem.
- Previous attempts to solve the problem and the office that had been contacted.
- A description of the hardship the organization is facing (if applicable).

The organization may contact a Taxpayer Advocate by calling a toll-free number, 1-877-777-4778. Persons who have access to TTY/TTD equipment may call 1-800-829-4059 and ask for Taxpayer Advocate assistance. If the organization prefers, it may call, write, or fax to the Taxpayer Advocate office in its area. See **Pub. 1546**, The Taxpayer Advocate Service of the IRS, for a list of addresses and fax numbers.

Phone Help

If you have questions and/or need help completing this form, please call **1-877-829-5500**. This toll-free telephone service is available Monday through Friday from 8:00 a.m. to 9:30 p.m. Eastern time.

How To Get Forms and Publications

Personal Computer

You can access the IRS Web Site 24 hours a day, 7 days a week at **www.irs.gov** to:

- Download forms, instructions, and publications.
- See answers to frequently asked tax questions.
- Search publications on-line by topic or keyword.
- Send us comments or request help by e-mail.
- Sign up to receive local and national tax news by e-mail.

You can also reach us using file transfer protocol at **ftp.irs.gov**.

CD-ROM

Order **Pub. 1796**, Federal Tax Products on CD-ROM, and get:

- Current year forms, instructions, and publications.
- Prior year forms, instructions, and publications.

- Frequently requested forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM on the Internet at www.irs.gov/cdorders from the National Technical Information Service (NTIS) for \$21 (no handling fee), or call **1-877-CDFORMS** (1-877-233-6767) toll-free to buy the CD-ROM for \$21 (plus a \$5 handling fee).

By Phone and In Person

You can order forms and publications 24 hours a day, 7 days a week, by calling **1-800-TAX-FORM** (1-800-829-3676). You can also get most forms and publications at your local IRS office.

General Instructions

Purpose of Form

Use **Form 990-T**, Exempt Organization Business Income Tax Return, to:

- Report unrelated business income;
- Figure and report unrelated business income tax liability;
- Report proxy tax liability;
- Claim a refund of income tax paid by a regulated investment company (RIC) or a real estate investment trust (REIT) on undistributed long-term capital gain.

Who Must File

- Any domestic or foreign organization exempt under section 501(a) or section 529(a) must file Form 990-T if it has gross income from an unrelated trade or business of \$1,000 or more. See Regulations section 1.6012-2(e). Gross income is gross receipts minus the cost of goods sold. (See Regulations section 1.61-3.)

Note — Disregarded entity. A *disregarded entity*, as described in Regulations sections 301.7701-1 through 301.7701-3, is treated as a branch or division of its parent organization for Federal tax purposes. Therefore, financial information applicable to a disregarded entity must be reported as the parent organization's financial information.

- Organizations liable for the proxy tax on lobbying and political expenditures must file Form 990-T. See the line 37 instructions on page 13 for a discussion of the proxy tax. If your organization is only required to file Form 990-T because of the proxy tax, see **Proxy Tax Only** under **Which Parts To Complete**, on page 4.

- Colleges and universities of states and other governmental units, as well as subsidiary corporations wholly owned by such colleges and universities, are also subject to the Form 990-T filing requirements. However, a section 501(c)(1) corporation that is an instrumentality of the United States and both organized and exempted from tax by an Act of Congress does not have to file.

- Organizations that are liable for other taxes (such as the section 1291 tax (line 35c or 36 of Form 990-T) or recapture taxes (line 42 of Form 990-T)) must file Form 990-T. See pages 13 and 14 of the instructions for a discussion of these items. If your organization is only required to file Form 990-T because of these taxes, see **Other Taxes** under **Which Parts To Complete**, on page 4.

- Fiduciaries for the following trusts that have \$1,000 or more of unrelated trade or business gross income must file Form 990-T:

1. Individual Retirement Accounts (IRAs) described under section 408(a),
2. Simplified Employee Pensions (SEPs) described under section 408(k),
3. Simple Retirement Accounts (SIMPLE) described under section 408(p),
4. Roth IRAs described under section 408A(b),
5. Coverdell education savings accounts (ESAs) described under section 530(b), and
6. Archer Medical Savings Accounts (Archer MSAs) described under section 220(d).

TIP *IRAs and other tax-exempt shareholders in a RIC or REIT filing Form 990-T only to obtain a refund of income tax paid on undistributed long-term capital gains should complete Form 990-T as explained in IRAs and other tax exempt shareholders in a RIC or REIT under Which Parts To Complete, on page 4.*

Definitions

Unrelated trade or business income.

Unrelated trade or business income is the gross income derived from any *trade or business* (defined on page 3) that is regularly carried on, and *not substantially related to* (defined on page 3), the organization's exempt purpose or function (aside from the organization's need for income or funds or the use it makes of the profits).

Generally, for section 501(c)(7), (9), or (17) organizations, unrelated trade or business income is derived from nonmembers with certain modifications (see section 512(a)(3)(A)).

For a section 511(a)(2)(B) state college or university, unrelated trade or business income is derived from activities not substantially related to exercising or performing any purpose or function described in section 501(c)(3).

An unrelated trade or business does **not** include a trade or business:

1. In which substantially all the work is performed for the organization without compensation; or
2. That is carried on by a section 501(c)(3) or 511(a)(2)(B) organization mainly for the convenience of its

members, students, patients, officers, or employees; or

3. That sells items of work-related equipment and clothes, and items normally sold through vending machines, food dispensing facilities or by snack bars, by a local association of employees described in section 501(c)(4), organized before May 27, 1969, if the sales are for the convenience of its members at their usual place of employment; or

4. That sells merchandise substantially all of which was received by the organization as gifts or contributions; or

5. That consists of qualified public entertainment activities regularly carried on by a section 501(c)(3), (4), or (5) organization as one of its substantial exempt purposes (see section 513(d)(2) for the meaning of qualified public entertainment activities); or

6. That consists of qualified convention or trade show activities regularly conducted by a section 501(c)(3), (4), (5), or (6) organization as one of its substantial exempt purposes (see section 513(d)(3) for the meaning of qualified convention and trade show activities); or

7. That furnishes one or more services described in section 501(e)(1)(A) by a hospital to one or more hospitals subject to conditions in section 513(e); or

8. That consists of qualified pole rentals (as defined in section 501(c)(12)(D)), by a mutual or cooperative telephone or electric company; or

9. That includes activities relating to the distribution of low-cost articles, each costing \$7.60 or less by an organization described in section 501 and contributions to which are deductible under section 170(c)(2) or (3) if the distribution is incidental to the solicitation of charitable contributions; or

10. That includes the exchange or rental of donor or membership lists between organizations described in section 501 and contributions to which are deductible under section 170(c)(2) or (3); or

11. That consists of bingo games as defined in section 513(f). Generally, a bingo game is not included in any unrelated trade or business if:

a. Wagers are placed, winners determined, and prizes distributed in the presence of all persons wagering in that game, and

b. The game does not compete with bingo games conducted by for-profit businesses in the same jurisdiction, and

c. The game does not violate state or local law; or

12. That consists of conducting any game of chance by a nonprofit organization in the state of North Dakota, and the conducting of the game does not violate any state or local law; or

13. That consists of soliciting and receiving qualified sponsorship payments that are solicited or received after December 31, 1997. Generally, qualified sponsorship payment means any payment to a tax-exempt organization by a person engaged in a trade or business in which there is no arrangement or expectation of any substantial return benefit by that person—other than the use or acknowledgment of that person's name, logo, or product lines in connection with the activities of the tax-exempt organization. See section 513(i) for more information.

Trade or business. A trade or business is any activity carried on for the production of income from selling goods or performing services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may or may not be related to the exempt purpose of the organization. If, however, an activity carried on for profit is an *unrelated trade or business*, no part of it can be excluded from this classification merely because it does not result in profit.

Not substantially related to. Not substantially related to means that the activity that produces the income does not contribute importantly to the exempt purposes of the organization, other than the need for funds, etc. Whether an activity contributes importantly depends in each case on the facts involved.

For details, see **Pub. 598**, Tax on Unrelated Business Income of Exempt Organizations.

Directly connected expenses. To be deductible in computing unrelated business taxable income, expenses, depreciation, and similar items must qualify as deductions allowed by section 162, 167, or other relevant provisions of the Code, and must be *directly connected* with the carrying on of an unrelated trade or business activity.

To be *directly connected* with the carrying on of a trade or business activity, expenses, depreciation, and similar items must bear a proximate and primary relationship to the conduct of the activity. For example, where facilities and/or personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such facilities and/or personnel must be allocated between the two uses on a reasonable basis. The portion of any such item allocated to the unrelated trade or business activity must bear a proximate and primary relationship to that business activity.

When To File

An employees' trust defined in section 401(a), an IRA (including SEPs and SIMPLEs), a Roth IRA, a Coverdell ESA, and an Archer MSA must file Form 990-T

by the **15th day of the 4th month** after the end of the tax year. All other organizations, must file Form 990-T by the **15th day of the 5th month** after the end of the tax year. If the regular due date falls on a Saturday, Sunday, or legal holiday, file on the next business day. If the return is filed late, see the discussion of **Interest and Penalties** on page 4.

Extension. Corporations may request an automatic 6-month extension of time to file Form 990-T by using **Form 8868**, Application for Extension of Time To File an Exempt Organization Return.

Trusts may request an automatic 3-month extension of time to file by using Form 8868. Also, if more than the initial automatic 3 months is needed, trusts may request on a second Form 8868 that an additional, but not automatic, 3 months may be granted by the IRS.

Amended return. To correct errors or change a previously filed return, write "Amended Return" at the top of the return. Also, include a statement that indicates the line number(s) on the original return that was changed and give the reason for each change. Generally, the amended return must be filed within 3 years after the date the original return was due or 3 years after the date the organization filed it, whichever is later.

Where To File

To file Form 990-T, mail or deliver it to:
Internal Revenue Service Center
Ogden, UT 84201-0027

Private delivery services (PDSs). In addition to the United States mail, exempt organizations can use certain PDSs designated by the IRS to meet the "timely mailing as timely filing/paying" rule for tax returns and payments. The most recent list of designated PDSs was published by the IRS in October 2001. This list includes only the following:

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, Second Day Service.
- DHL Worldwide Express (DHL): DHL "Same Day" Service, DHL USA Overnight.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2 Day.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

The private delivery service can tell you how to get written proof of the mailing date.

Estimated Taxes

Generally, an organization filing Form 990-T must make installment payments of estimated tax if its estimated tax (tax minus allowable credits) is expected to be \$500 or more. Both corporate and trust organizations use **Form 990-W**, Estimated Tax on Unrelated Business

Taxable Income for Tax-Exempt Organizations, to figure their estimated tax liability. **Do not** include the proxy tax when computing your estimated tax liability for 2002.

To figure estimated tax, trusts and corporations must take the alternative minimum tax (if applicable) into account. See Form 990-W for more information.

Depository Method of Tax Payment

The organization must pay the tax due in full by the due date of the return without extensions. Some organizations (described below) are required to electronically deposit all depository taxes, including their unrelated business income tax payments.

Electronic Deposit Requirement

The organization must make electronic deposits of **all** depository tax (such as employment tax, excise tax, unrelated business income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2002 if:

- The total deposits in 2000 were more than \$200,000 or
- The organization was required to use EFTPS in 2001.

If an organization is required to use EFTPS and fails to do so, it may be subject to a 10% penalty. If an organization is not required to use EFTPS, it may participate voluntarily. To enroll in or get more information about EFTPS, call 1-800-555-4477 or 1-800-945-8400. To enroll online, visit **www.irs.gov**.

Depositing on time. For EFTPS deposits to be made timely, the organization must initiate the transaction at least 1 business day before the date the deposit is due.

Deposits With Form 8109

If the organization does not use EFTPS, deposit unrelated business income tax payments (and estimated tax payments) with **Form 8109**, Federal Tax Deposit Coupon. If you do not have a preprinted Form 8109, you may use Form 8109-B to make deposits. You can get this form only by calling 1-800-829-1040. Be sure to have your EIN ready when you call.

Do not send deposits directly to an IRS office; otherwise, the organization may have to pay a penalty. Mail or deliver the completed Form 8109 with the payment to an authorized depository, i.e., a commercial bank or other financial institution authorized to accept Federal tax deposits.

Make checks or money orders payable to the depository. To help ensure proper crediting, write the organization's EIN, the tax period to which the deposit applies, and "Form 990-T" on the check or money order. Be sure to darken the "990-T" box on the coupon. Records of these deposits will be sent to the IRS.

If the organization prefers, it may mail the coupon and payment to: Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, MO 63197. Make the check or money order payable to "Financial Agent."

For more information on deposits, see the instructions in the coupon booklet (Form 8109) and **Pub. 583**, Starting a Business and Keeping Records.



If the organization owes tax when it files Form 990-T, do not include the payment with the tax return. Instead, mail or deliver the payment with Form 8109 to an authorized depository, or use the EFTPS, if applicable.

Interest and Penalties

Your organization may be subject to interest and penalty charges if it files a late return or fails to pay tax when due. Generally, the organization is not required to include the interest and penalty charges on Form 990-T because the IRS can figure the amount and bill the organization for it.

Interest. Interest is charged on taxes not paid by the due date even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, gross valuation overstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at the underpayment rate determined under section 6621(a)(2).

Penalty for late filing of return. An organization that fails to file its return when due (including extensions of time for filing) is subject to a penalty of 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or \$100. The penalty will not be imposed if the organization can show that the failure to file on time was due to reasonable cause. Organizations that file late must attach a statement explaining the reasonable cause.

Penalty for late payment of tax. The penalty for late payment of taxes is usually $\frac{1}{2}$ of 1% of the unpaid tax for each month or part of a month the tax is unpaid. The penalty cannot exceed 25% of the unpaid tax. The penalty will not be imposed if the organization can show that the failure to pay on time was due to reasonable cause.

Estimated tax penalty. An organization that fails to make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. Generally, an organization is subject to this penalty if its tax liability is \$500 or more and it did not make estimated tax payments of at least the smaller of its tax liability for 2001, or 100%

of the prior year's tax. See section 6655 for details and exceptions.

Form 2220, Underpayment of Estimated Tax by Corporations, is used by corporations and trusts filing Form 990-T to see if the organization owes a penalty and to figure the amount of the penalty. Generally, the organization is not required to file this form because the IRS can figure the amount of any penalty and bill the organization for it. However, even if the organization does not owe the penalty, you must complete and attach Form 2220 if either of the following applies:

- The annualized income or adjusted seasonal installment method is used.
- The organization is a "large organization" computing its first required installment based on the prior year's tax.

If you attach Form 2220, be sure to check the box on line 46, page 2, Form 990-T, and enter the amount of any penalty on this line.

Trust fund recovery penalty. This penalty may apply if certain excise, income, social security, and Medicare taxes that must be collected or withheld are not paid to the United States Treasury. These taxes are generally reported on Forms 720, 941, 943, or 945. The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been **responsible** for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax. See the instructions for Form 720, **Pub. 15 (Circular E)**, Employer's Tax Guide, or **Pub. 51 (Circular A)**, Agricultural Employer's Tax Guide, for details, including the definition of responsible persons.

Other penalties. There are also penalties that can be imposed for negligence, substantial understatement of tax, and fraud. See sections 6662 and 6663.

Which Parts To Complete



*If you are filing Form 990-T only because of the proxy tax, other taxes, or only to claim a refund, go directly to **Proxy Tax Only**, **Other Taxes**, or **Claim for Refund** (see below).*

Is Gross Income More Than \$10,000?

If the amount on line 13, column (A), Part I, is more than \$10,000, complete all lines and schedules that apply.

Is Gross Income \$10,000 or Less?

If Part I, line 13, column (A) is \$10,000 or less, then complete:

- The heading (the area above Part I).
- Part I, column (A) lines 1-13.
- Part I, line 13, for columns (B) and (C).
- Part II, lines 29-34.
- Parts III-V.
- Signature area.

Filers with \$10,000 or less on line 13, column (A) **do not** have to complete Schedules A through K (however, refer to applicable schedules when completing column (A) and in determining the deductible expenses to include on line 13 of column (B)).

Proxy Tax Only

Organizations that are required to file Form 990-T only because they are liable for the proxy tax on lobbying and political expenditures must:

- Fill-in the heading (the area above Part I) except items E, H, and I.
- Enter the proxy tax on lines 37 and 39.
- Complete Part IV and the Signature area.
- Attach a schedule showing the proxy tax computation.

Other Taxes

Organizations that are required to file Form 990-T only because they are liable for recapture taxes, the section 1291 tax, or other items listed in the instructions for line 42 must:

- Fill-in the heading (the area above Part I) except items E, H, and I.
- Complete the appropriate lines of Parts III and IV.
- Complete the Signature area.
- Attach all appropriate forms and or schedules showing the computation of the applicable tax or taxes.

Claim For Refund

If your only reason for filing a Form 990-T is to claim a refund, complete the following steps:

1. Fill-in the heading (the area above Part I) except items E, H, and I.
2. Enter -0- on line 13, column (A), line 34, and line 43.
3. Enter the credit or payment on the appropriate line (44a-44f).
4. Complete lines 45, 48, and 49 and the Signature area.
5. For claims described below, follow the additional instructions for that claim.

IRAs and other tax-exempt shareholders in a RIC or REIT. If you are an IRA or other tax-exempt shareholder that is invested in a RIC or a REIT and file Form 990-T only to obtain a refund of income tax paid on undistributed long-term capital gains, follow steps 1-4 above; write "Claim for Refund Shown on Form 2439" at the top of the Form 990-T; and attach to the return **Copy B of Form 2439**, Notice to Shareholder of Undistributed Long-Term Capital Gains.

Composite Form 990-T. If you are a trustee of more than one IRA invested in a RIC, you may be able to file a composite Form 990-T to claim a refund of tax under section 852(b) instead of filing a separate Form 990-T for each IRA. See Notice 90-18, 1990-1 C.B. 327, for information on who can file a composite return. Complete steps 1-4

above and follow the additional requirements of the notice.

Backup withholding. If your only reason for filing Form 990-T is to claim a refund for backup withholding, complete the parts discussed on page 4 in steps 1-4 and attach a copy of the Form 1099 showing the withholding.

Consolidated Returns

The consolidated return provisions of section 1501 do not apply to exempt organizations, except for organizations having title holding companies. If a title holding corporation described in section 501(c)(2) pays any amount of its net income for a tax year to an organization exempt from tax under section 501(a) (or would, except that the expenses of collecting its income exceeded that income), and the corporation and organization file a consolidated return as described below, then treat the title holding corporation as being organized and operated for the same purposes as the other exempt organization (in addition to the purposes described in section 501(c)(2)).

Two organizations exempt from tax under section 501(a), one a title holding company, and the other earning income from the first, will be includible corporations for purposes of section 1504(a). If the organizations meet the definition of an affiliated group, and the other relevant provisions of Chapter 6 of the Code, then these organizations may file a consolidated return. The parent organization must attach **Form 851**, Affiliations Schedule, to the consolidated return. For the first year a consolidated return is filed, the title holding company must attach **Form 1122**, Authorization and Consent of Subsidiary Corporation To Be Included in a Consolidated Income Tax Return. See Regulations section 1.1502-100 for more information on consolidated returns.

Disclosure Statement for Corporate Tax Shelters

An organization is required to disclose its participation in **certain** tax shelters:

- By attaching a disclosure statement to its income tax return for a reportable transaction for each tax year its income tax liability is affected by its participation in the transaction and
- For the first tax year a disclosure statement is attached to its tax return by sending a copy of the disclosure statement to the;

Internal Revenue Service
LM:PFTG:OTSA
Large & Mid-Size Business Division
1111 Constitution Ave., NW
Washington, DC 20224.

Disclosure is required for reportable transactions that are: **(a)** listed transactions that the IRS has identified as a tax avoidance transaction and **(b)** other reportable transactions that have tax

shelter characteristics. A listed transaction must be reported if it is expected to reduce the taxpayer's income tax liability by more than \$1 million in a single tax year or by a total of more than \$2 million for any combination of years. For other reportable transactions, the threshold, increases to \$5 million for a single tax year or to \$10 million for any combination of years. Generally, reporting is not required for customary business transactions or transactions with tax benefits that the IRS has no reasonable basis to challenge.

See Temporary Regulations section 1.6011-4T for details, including:


- The definition of a reportable transaction and a listed transaction,
- The relevant tax shelter characteristics for other reportable transactions,
- The form and contents of the disclosure statement, and
- The filing requirements of the disclosure statement.

Also, see Notice 2001-51, 2001-34 I.R.B. 190, for certain listed transactions determined to have a tax avoidance purpose and the intended tax benefits that are subject to disallowance. The listed transactions in this notice may be updated from time to time when other tax avoidance transactions are identified.

Other Forms You May Need To File

Form W-2, Wage and Tax Statement, and **Form W-3**, Transmittal of Wage and Tax Statements. Use these forms to report wages, tips, other compensation, withheld income taxes, and withheld social security/Medicare taxes for employees.

Form 720. Use Form 720, Quarterly Federal Excise Tax Return, to report environmental excise taxes, communications and air transportation taxes, fuel taxes, luxury tax on passenger vehicles, manufacturers taxes, ship passenger tax, and certain other excise taxes.

 See **Trust fund recovery penalty** on page 4.

Form 926. File Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, if the organization is required to report certain transfers to foreign corporations under section 6038B.

Form 940 or **Form 940-EZ**. The organization must file Form 940 or Form 940-EZ, Employers's Annual Federal Unemployment (FUTA) Tax Return, if it is liable for FUTA tax.


Form 941 or **Form 943**. The organization must file Form 941, Employer's Quarterly Federal Tax Return, or Form 943, Employer's Annual Tax Return for Agricultural Employees, to report income tax withheld, and employer and employee social security and Medicare taxes. Also,

see **Trust fund recovery penalty** on page 4.

Form 945. Use Form 945, Annual Return of Withheld Federal Income Tax, to report income tax withheld from nonpayroll distributions or payments, including pensions, annuities, IRAs, gambling winnings, and backup withholding.

Form 1098. Use Form 1098, Mortgage Interest Statement, to report the receipt from any individual of \$600 or more of mortgage interest (including points) in the course of the organization's trade or business and reimbursements of overpaid interest.

Information returns. Organizations engaged in an unrelated trade or business may be required to file an information return on **Forms 1099-A, B, DIV, INT, LTC, MISC, MSA, OID, R, and S**, to report acquisitions or abandonments of secured property through foreclosure; proceeds from broker and barter exchange transactions; certain dividends and distributions; interest income; certain payments made on a per diem basis under a long-term care insurance contract, and certain accelerated death benefits; miscellaneous income (e.g., payments to providers of health and medical services, miscellaneous income payments, and nonemployee compensation); distributions from an Archer MSA; original issue discount; distributions from retirement or profit-sharing plans, IRAs, SEPs, or SIMPLEs, and insurance contracts; and proceeds from real estate transactions.

 When filing the above noted information returns the organization must also file **Form 1096**, Annual Summary and Transmittal of U.S. Information Returns.

Form 4466. Use Form 4466, Corporation Application for Quick Refund of Overpayment of Estimated Tax, to apply for a quick refund, if the organization overpaid its estimated tax for the year by at least 10% of its expected income tax liability and at least \$500.

Form 5498. Use Form 5498, IRA and Coverdell ESA Contribution Information, to report contributions (including rollover contributions) to any IRA, including a SEP, SIMPLE, Roth IRA, Coverdell ESA, Roth conversions, IRA recharacterization, and the fair market value of the account.

Form 5498-MSA. Use Form 5498-MSA, Archer MSA or Medicare+Choice MSA Information, to report contributions to an Archer MSA and the fair market value of an Archer MSA or Medicare+Choice MSA. For more information see the general and specific Instructions for Forms 1099, 1098, 5498, and W-2G.

Form 5713. File Form 5713, International Boycott Report, if the organization had operations in, or related to, certain "boycotting" countries.

Form 6198. File Form 6198, At-Risk Limitations, if the organization has a loss

from an at-risk activity carried on as a trade or business or for the production of income.

Form 8275 and 8275-R. Taxpayers and income tax return preparers use Form 8275, Disclosure Statement, and Form 8275-R, Regulation Disclosure Statement, to disclose items or positions taken on a tax return or that are contrary to Treasury regulations (to avoid parts of the accuracy-related penalty or certain preparer penalties).

Form 8300. File Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business, if the organization received more than \$10,000 in cash or foreign currency in one transaction or in a series of related transactions. For more information, see Form 8300 and Regulations section 1.60501-1(c).

Form 8697. Use Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, to figure the interest due or to be refunded under the look-back method of section 460(b)(2). The look-back method applies to certain long-term contracts that are accounted for under either the percentage method or the completion-capitalized cost method.

Form 8865, Return of U.S. Person With Respect To Certain Foreign Partnerships. An organization may have to file Form 8865 if it:

1. Controlled a foreign partnership (i.e., owned more than a 50% direct or indirect interest in the partnership).
2. Owned at least a 10% direct or indirect interest in a foreign partnership while U.S. persons controlled that partnership.
3. Had an acquisition, disposition, or change in proportional interest in a foreign partnership that:
 - a. Increased its direct interest to at least 10% or reduced its direct interest of at least 10% to less than 10%.
 - b. Changed its direct interest by at least a 10% interest.
4. Contributed property to a foreign partnership in exchange for a partnership interest if:
 - a. Immediately after the contribution, the corporation owned, directly or indirectly, at least a 10% interest in the foreign partnership; or
 - b. The FMV of the property the corporation contributed to the foreign partnership in exchange for a partnership interest, when added to other contributions of property made to the foreign partnership during the preceding 12-month period, exceeds \$100,000.

Also, the organization may have to file Form 8865 to report certain dispositions by a foreign partnership of property it previously contributed to that foreign partnership if it was a partner at the time

of the disposition. For more details, including penalties that may apply, see Form 8865 and its separate instructions.

Form 8873, Extraterritorial Income Exclusion. Use this form to report the amount of extraterritorial income that is excluded from the organization's gross income for the tax year.

Accounting Methods

Figure the taxable income using the method of accounting regularly used in keeping the organization's books and records. In all cases, the method adopted must clearly reflect taxable income. See section 446. Permissible methods include the cash, accrual, or any other method authorized by the Internal Revenue Code. However, organizations with average annual gross receipts of more than \$5 million must generally use the accrual method of accounting for their unrelated trade or business activities. See section 448(c).

In all cases the method used must clearly show taxable income. If inventories are required, the accrual method must be used for sales and purchases of merchandise. However, if the organization is a qualifying taxpayer under Rev. Proc. 2001-10, 2001-2 I.R.B. 272 (i.e., has average gross receipts of \$1 million or less and is not a tax shelter), the organization is excepted from the requirements to use an accrual method and may account for inventory items as materials and supplies that are not incidental. See Rev. Proc. 2001-10 and **Schedule A—Cost of Goods Sold** on page 16.

An organization changing to the accrual method because of this provision must complete **Form 3115,** Application for Change in Accounting Method, and attach it to Form 990-T for the year of change. An organization must also show on a statement accompanying Form 3115 the period over which the section 481(a) adjustment will be taken into account and the basis for that conclusion. See Rev. Proc. 99-49, 1999-2 C.B. 725, as well as section 448 and Regulations sections 1.448-1(g) and 1.448-1(h) for more information on figuring this adjustment for 2001. Include any positive section 481(a) adjustment on line 12, page 1. If the section 481(a) adjustment is a negative, report it on line 28, page 1.

See section 460 for rules on long-term contracts.

Unless the law specifically permits otherwise, the organization may change the method of accounting used to report income in earlier years (for income as a whole or for any material item) only by first getting consent on Form 3115. Also see **Pub. 538,** Accounting Periods and Methods.

Accounting Period

The return must be filed using the organization's established annual accounting period. If the organization has no established accounting period, file the return on the calendar-year basis.

To change an accounting period, some organizations may make a notation on a timely filed Form 990, 990-EZ, 990-PF, or 990-T. Others may be required to file **Form 1128,** Application To Adopt, Change, or Retain a Tax Year. For details on which procedure applies to your organization, see Rev. Proc. 85-58, 1985-2 C.B. 740, and the instructions for Form 1128.

If the organization changes its accounting period, file Form 990-T for the short period that begins with the first day after the end of the old tax year and ends on the day before the first day of the new tax year. For the short period return, figure the tax by placing the organization's taxable income on an annual basis. For details, see Pub. 538 and section 443.

Reporting Form 990-T Information on Other Returns

Your organization may be required to file an annual information return on:

- **Form 990,** Return of Organization Exempt From Income Tax;
- **Form 990-EZ,** Short Form Return of Organization Exempt From Income Tax;
- **Form 990-PF,** Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation; **OR**
- **Form 5500,** Annual Return/Report of Employee Benefit Plan.

If so, include on that information return the unrelated business gross income and expenses (but not including the specific deduction claimed on line 33, page 1, or any expense carryovers from prior years) reported on Form 990-T for the same tax year.

Rounding Off to Whole Dollars

The organization may show amounts on the return and accompanying schedules as whole-dollars. To do so, drop any amount less than 50 cents and increase any amount from 50 cents through 99 cents to the next higher dollar.

Attachments

If you need more space on the form or schedules, attach separate sheets. On the attachment, write the corresponding form or schedule number or letter and follow the same format. **Show totals on the printed form.** Also, include the organization's name and EIN. The separate sheets should be the same size as the printed form and should be attached after the printed form.

Specific Instructions

Period Covered

File the 2001 return for calendar year 2001 or a fiscal year beginning in 2001 and ending 2002. For a fiscal year, fill in the tax year information at the top of the form.


Note: *The 2001 Form 990-T may also be used if:*

- The organization has a tax year of less than 12 months that begins and ends in 2002 and
- The 2002 Form 990-T is not available at the time the organization is required to file its return. The organization must show its 2002 tax year on the 2001 Form 990-T and take into account any tax law changes that are effective for tax years beginning after December 31, 2001.

Name and Address

The name and address on Form 990-T should be the same as the name and address shown on the preprinted mailing label on Package 990 (or 990-PF). If any information on the label is incorrect or missing, cross out any errors, print the correct information, and add any missing information.


Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the organization has a P.O. box, show the box number instead of the street address.

 **Change of name.** *If the organization has changed its name, it must check the box next to "Name of organization" and also provide the following when filing this return, if it is:*

- A corporation or is incorporated with the state, an amendment to the articles of incorporation along with proof of filing with the state is required.
- A trust, an amendment to the trust agreement is required along with the trustee(s) signature.
- An association or an unincorporated association, an amendment to the articles of association, constitution, by-laws or other organizing document is required along with signatures of at least two officers/members.

Blocks A through J

Block A. If the organization has changed its address since it last filed a return, check Block A.

 **If a change in address occurs after the return is filed, use Form 8822, Change of Address, to notify the IRS of the new address.**

Block B. Check the box under which the organization receives its tax exemption.

Qualified pension, profit-sharing, and stock bonus plans should check the 501

box and enter "a" between the first set of parenthesis.

For other organizations exempt under section 501, check the box for 501 and enter the section that describes their tax exempt status, for example, 501(c)(3).

For tax exempts that **do not** receive their exemption under section 501, use the following guide.

If you are a	Then check this box
IRA, SEP, or SIMPLE	408(e)
Roth IRA	408A
Archer MSA	220(e)
Coverdell ESA	530(a)
Qualified State Tuition Program	529(a)

Block C. Enter the total of the end-of-year assets from the organization's books of account.

Block D. An employees' trust described in section 401(a) and exempt under section 501(a) should enter its own trust identification number in this block.

An IRA trust enters its own EIN in this block. An IRA trust *never* uses a social security number or the trustee's EIN.

An EIN is obtained by filing **Form SS-4**, Application for Employer Identification Number.

Block E. Enter the applicable unrelated business activity code(s) that specifically describes the organization's unrelated business activity. If a specific activity code does not accurately describe the organization's activities, then choose a general code that best describes its activity. These codes are listed on page 20.

Block F. If the organization is covered by a group exemption, enter the group exemption number.

Block G. Check the box that describes your organization.

"Other trust" includes IRAs, SEPs, SIMPLEs, Roth IRAs, Coverdell IRAs, and Archer MSAs.

Section 529 organizations check the 501(c) corporation or 501(c) trust box depending on whether the organization is a corporation or a trust. Also, be sure the box for 529(a) in Block B is checked.

If you check "501(c) corporation," leave line 36 blank. If you check "501(c) trust," "401(a) trust," or "Other trust" leave lines 35a, b, and c blank.

Block H. Describe the primary unrelated business activity of your organization based on unrelated income. Attach a schedule if more space is needed.

Block I. Check the "Yes" box if your organization is a corporation and either **1** or **2** below applies:

1. The corporation is a subsidiary in an affiliated group (defined in section

1504) but is not filing a consolidated return for the tax year with that group.

2. The corporation is a subsidiary in a parent-subsidiary controlled group (defined in section 1563).

Excluded member. If the corporation is an "excluded member" of a controlled group (see section 1563(b)(2)), it is still considered a member of a controlled group for purposes of Block I.

Block J. Enter the name of the person who has the organization's books and records and the telephone number at which he or she can be reached.


Part I—Unrelated Trade or Business Income

Complete column (A), lines 1 through 13. If the amount on line 13 is \$10,000 or less, you may complete only line 13 for columns (B) and (C). These filers do not have to complete Schedules A through K (however, refer to applicable schedules when completing column (A)). If the amount on line 13, column (A), is more than \$10,000, complete all lines and schedules that apply.

Extraterritorial income. Except as otherwise provided in the Internal Revenue Code, gross income includes all income from whatever source derived. Gross income, however, does not include extraterritorial income that is qualifying foreign trade income. Use Form 8873 to figure the exclusion. Report it on Form 990-T under "Other deductions," line 28.

Line 1a—Gross Receipts or Sales

Enter the gross income from any unrelated trade or business regularly carried on that involves the sale of goods or performance of services.

 **A section 501(c)(7) social club would report its restaurant and bar receipts from nonmembers on line 1, but would report its investment income on line 9 and in Schedule G.**

Advance payments. In general, advanced payments are reported in the year of receipt. To report income from long-term contracts, see section 460. For special rules for reporting certain advanced payments for goods and long-term contracts, see Regulations section 1.451-5. For permissible methods for reporting advanced payments for services by an accrual method organization, see Rev. Proc. 71-21, 1971-2 C.B. 549.

Installment sales. Generally, the installment method cannot be used for dealer dispositions of property. A "dealer disposition" is **(a)** any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan or **(b)** any disposition of real property held for sale to customers in the ordinary course of the taxpayer's

trade or business. These restrictions on using the installment method do not apply to dispositions of property used or produced in a farming business or sales of timeshares and residential lots for which the organization elects to pay interest under section 453(l)(3).

For sales of timeshares and residential lots reported under the installment method, the organization's income tax is increased by the interest payable under section 453(l)(3). To report this addition to the tax, see the instructions for line 42.

Enter on line 1a (and carry to line 3), the gross profit on collections from installment sales for any of the following:

- Dealer dispositions of property before March 1, 1986.
- Dispositions of property used or produced in the trade or business of farming.
- Certain dispositions of timeshares and residential lots reported under the installment method.

Attach a schedule showing the following information for the current and the 3 preceding years:

1. Gross sales,
2. Cost of goods sold,
3. Gross profits,
4. Percentage of gross profits to gross sales,
5. Amount collected, and
6. Gross profit on amount collected.

Nonaccrual experience method.

Accrual basis taxpayers need not accrue certain amounts to be received from the performance of services that, on the basis of their experience, will not be collected (section 448(d)(5)). This provision does not apply to any amount if interest is required to be paid on the amount or if there is any penalty for failure to pay the amount on time. Organizations that fall under this provision should attach a schedule showing total gross receipts, amounts not accrued as a result of the application of section 448(d)(5), and the net amount accrued. Enter the net amount on line 1a.

For more information and guidelines on this "nonaccrual experience method," see Temporary Regulations section 1.448-2T.

Line 4a—Capital Gain Net Income

Generally, organizations required to file Form 990-T (except organizations described in sections 501(c)(7), (9), and (17)) are not taxed on the net gains from the sale, exchange, or other disposition of property. However, net capital gains on debt-financed property, capital gains on cutting timber, and ordinary gains on sections 1245, 1250, 1252, 1254, and 1255 property are taxed. See **Form 4797**, Sales of Business Property, and its instructions for additional information.

Also, any capital gain or loss passed through from an S corporation or any gain

or loss on the disposition of S corporation stock by a *qualified tax exempt* (see **S Corporations** under the line 5 instructions) is taxed as a capital gain or loss.

Capital gains and losses should be reported by a trust on **Schedule D (Form 1041)**, Capital Gains and Losses, and by a corporation on **Schedule D (Form 1120)**, Capital Gains and Losses.

An organization that transfers securities it owns for the contractual obligation of the borrower to return identical securities recognizes no gain or loss. To qualify for this treatment, the organization must lend the securities under an agreement that requires:

1. The return of identical securities;
2. The payment of amounts equivalent to the interest, dividends, and other distributions that the owner of the securities would normally receive; and
3. The risk of loss or opportunity for gain not be lessened.

See section 512(a)(5) for details.

Debt-financed property disposition.

The amount of gain or loss to be reported on the sale, exchange, or other disposition of debt-financed property is the same percentage as the highest acquisition indebtedness for the property for the 12-month period before the date of disposition is to the average adjusted basis of the property. The percentage may not be more than 100%. See the instructions for Schedule E, column 5, to determine adjusted basis and average adjusted basis.

If debt-financed property is depreciable or depletable property, the provisions of sections 1245, 1250, 1252, 1254, and 1255 must be considered first.

Example. On January 1, 2000, an exempt educational corporation, using \$288,000 of borrowed funds, purchased an office building for \$608,000. The only adjustment to basis was \$29,902 for depreciation (straight line method under MACRS over the 39-year recovery period for nonresidential real property). The corporation sold the building on December 31, 2001, for \$640,000. At the date of sale, the adjusted basis of the building was \$578,098 (\$608,000 – \$29,902) and the indebtedness remained at \$288,000. The adjusted basis of the property on the first day of the year of disposition was \$593,037. The average adjusted basis is \$585,568 $(\$593,037 + \$578,098) \div 2$. The debt/basis percentage is 49% $(\$288,000 \div \$585,568)$.

The taxable gain is \$30,332 $(49\% \times (\$640,000 - \$578,098))$. This is a long-term capital gain. A corporation should enter the gain on line 6, Part II, Schedule D (Form 1120). A trust should enter the gain on Schedule D (Form 1041). Both should attach a statement to

the return showing how the gain was figured.

Line 4b—Net Gain or (Loss)

Show gains and losses on other than capital assets on Form 4797. Enter on this line the net gain or (loss) from Part II, line 18, Form 4797.

An exempt organization using Form 4797 to report ordinary gain on sections 1245, 1250, 1252, 1254, and 1255 property will include only depreciation, amortization, or depletion allowed or allowable in figuring unrelated business taxable income or taxable income of the organization (or a predecessor organization) for a period when it was not exempt.

Line 4c—Capital Loss Deduction for Trusts

If a trust has a net capital loss, it is subject to the limitations of Schedule D (Form 1041). Enter on this line the loss figured on Schedule D (Form 1041).

Line 5—Income or (Loss) From Partnerships and S Corporations

Combine all partnership income or loss (determined below) with all S corporation income or loss and enter it on line 5.

However, for limitations on losses for certain activities, see Form 6198 and, for trusts, **Form 8582**, Passive Activity Loss Limitations, or, for corporations, **Form 8810**, Corporate Passive Activity Loss and Credit Limitations, and sections 465 and 469.

Partnerships

If the organization is a partner in a partnership carrying on an unrelated trade or business, enter the organization's share (whether or not distributed) of the partnership's income or loss from the unrelated trade or business.

Figure the gross income and deductions of the partnership in the same way you figure unrelated trade or business income the organization earns directly.

Attachment. Attach a statement to this return showing the organization's share of the partnership's gross income from the unrelated trade or business, and its share of the partnership deductions directly connected with the unrelated gross income. Also, see **Attachments** on page 6 for other information you need to include.

S Corporations

For tax years beginning after December 31, 1997, *qualified tax exempts* can be shareholders in an S corporation without the S corporation losing its status as an S corporation. *Qualified tax exempts* that hold stock in an S corporation treat their stock interest as an unrelated trade or business. **All** items of income, loss, or deduction are taken into account in

figuring unrelated business taxable income. Report on line 4 any gain or loss on the disposition of S corporation stock.

Qualified tax exempts. A qualified tax exempt is an organization that is described in section 401(a) (qualified stock bonus, pension, and profit-sharing plans) or 501(c)(3) and exempt from tax under section 501(a).

Exception. Employer stock ownership plans (ESOPs) do not follow these S corporation rules if the S corporation stock is an employer security as defined in section 409(l).

Attachment. Attach a statement to this return showing the qualified tax exempt's share of all items of income, loss, or deduction. Show capital gains and losses separately and include them on line 4a. Combine the income, loss, and deductions (except for the capital gains and losses) on the statement. If you hold stock in more than one S corporation, total the combined amounts. Also, see **Attachments** on page 6 for other information you need to include.

Line 12—Other Income

Enter on line 12 any item of unrelated business income that is not reportable elsewhere on the return. Include recoveries of bad debts deducted in earlier years under the specific charge-off method. Attach a separate schedule of any items of other income to your return.

- **Organizations described in section 501(c)(19).** Enter the net income from insurance business that was not properly set aside. These organizations may set aside income from payments received for life, sick, accident, or health insurance for members of the organization or their dependents:

1. To provide for the payment of insurance benefits; or
2. For a purpose specified in section 170(c)(4) (religious, charitable, scientific, literary, educational, etc.); or
3. For administrative costs directly connected with benefits described in 1 and 2 above.

Amounts set aside and used for purposes other than those in 1, 2, or 3 above, must be included in unrelated business taxable income for the tax year if they were previously excluded from taxable income.

Any amount spent for a purpose described in section 170(c)(4) is first considered paid from funds earned by the organization from insurance activities if the income is not used for the insurance activities.

Expenditures for lobbying are not considered section 170(c)(4) expenses.

- **Income from property financed with qualified 501(c)(3) bonds.** If any part of the property is used in a trade or business of any person other than a section 501(c)(3) organization or a governmental unit, your section 501(c)(3) organization is

considered to have received unrelated business income in the amount of the greater of the actual rental income or the fair rental value of the property for the period it is used. No deduction is allowed for interest on the private activity bond. Report the greater of the actual rent or the fair rental value on line 12. Report allowable deductions in Part II. See section 150(b)(3) for more information.

- **Passive foreign investment company (PFIC) shareholders.** If your organization is a direct or indirect shareholder of a PFIC within the meaning of section 1296, it may have income tax consequences under section 1291 on the disposition of the PFIC stock or on receipt of an excess distribution from the PFIC, described in section 1291(a). Your organization may have current income under section 1293 if the PFIC is a qualified electing fund (QEF) with respect to the organization.

Include on line 12 the portion of an excess distribution or section 1293 inclusion that is taxable as unrelated business taxable income. See **Form 8621**, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, for more information on reporting excess distributions and current income inclusions.

See the instructions for **Lines 35c and 36** in Part III for reporting the deferred tax amount that may be owed by your organization with respect to an excess distribution.

Part II—Deductions Not Taken Elsewhere

If the amount on Part I, line 13, column (A), is \$10,000 or less, you do not have to complete lines 14 through 28 of Part II. However, you must complete lines 29 through 34 of Part II.

Directly connected expenses. Only expenses directly connected with unrelated trade or business income (except contributions) may be deducted on these lines (see **Directly connected expenses** on page 3). Contributions may be deducted, whether or not directly connected. Do not separately include in Part II any expenses that are reported in Schedules A through J, other than excess exempt expenses entered on line 26 and excess readership costs entered on line 27. For example, officers' compensation allocable to advertising income is reported on Schedule J only, and should not be included on Schedule K or line 14 of Part II.

Limitations on Deductions

The following items discuss certain areas in which the amount of the deduction may to some extent be limited.

Activities Lacking a Profit Motive

If income is attributable to an activity lacking a profit motive, a loss from the activity cannot be claimed on Form 990-T.

Therefore, in Part I, column (B) and Part II, the total of deductions for expenses directly connected with income from an activity lacking a profit motive is limited to the amount of that income. Generally, an activity lacking a profit motive is one that is not conducted for the purpose of producing a profit or one that has consistently produced losses when both direct and indirect expenses are taken into account.

Transactions Between Related Taxpayers

Generally, an accrual basis taxpayer may only deduct business expenses and interest owed to a related party in the year the payment is included in the income of the related party. See sections 163(e)(3), 163(j), and 267 for limitations on deductions for unpaid interest and expenses.

Preference Items

Corporations may be required to adjust deductions for depletion of iron ore and coal, intangible drilling and exploration and development costs, and the amortizable basis of pollution control facilities. See section 291 to determine the amount of the adjustment.

Section 263A Uniform Capitalization Rules

These rules require organizations to capitalize or include as inventory cost certain costs incurred in connection with:

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property held in inventory (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property produced by the organization for use in its trade or business or in an activity engaged in for profit.

Tangible personal property produced by an organization includes a film, sound recording, videotape, book, or similar property.

Indirect expenses. Organizations subject to the section 263A uniform capitalization rules are required to capitalize direct costs and an allocable part of most indirect costs (including taxes) that benefit the assets produced or acquired for resale or are incurred by reason of the performance of production or resale activities.

For inventory, some of the indirect expenses that must be capitalized are:

- Administration expenses,
- Taxes,
- Depreciation,
- Insurance,
- Compensation paid to officers attributable to services,
- Rework labor, and

- Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deductible.

Interest expense. Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules. For more details, see Regulations section 1.263A-8 through 1.263A-15.

When are section 263A capitalized costs deductible? The costs required to be capitalized under section 263A are not deductible until the property (to which the costs relate) is sold, used, or otherwise disposed of by the organization.

Exceptions. Section 263A does not apply to:

- Personal property acquired for resale if the organization's average annual gross receipts for the 3 prior tax years were \$10 million or less.
- Timber.
- Most property produced under long-term contract.
- Certain property produced in a farming business.
- Research and experimental costs under section 174.
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.
- Inventory of an organization that accounts for inventories in the same manner as materials and supplies that are not incidental. See **Schedule A—Cost of Goods Sold** on page 16 for details.

Additional information. For more details on the uniform capitalization rules, see Regulations sections 1.263A-1 through 1.263A-3.

Travel, Meals, and Entertainment

Subject to limitations and restrictions discussed below, an organization can deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Also, special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets. See section 274 and Pub. 463 for more details.

Travel. The organization cannot deduct travel expenses of any individual accompanying an organization's officer or employee, including a spouse or dependent of the officer or employee, unless:

- That individual is an employee of the organization and
- His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the organization can deduct only 50% of

the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition (subject to exceptions under section 274(k)(2)):

- Meals must not be lavish or extravagant;
- A bona fide business discussion must occur during, immediately before, or immediately after the meal; and
- An employee of the organization must be present at the meal.

Membership dues. The organization may deduct amounts paid or incurred for membership dues in civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for members or their guests. In addition, organizations may not deduct membership dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion.

Entertainment facilities. The organization cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.



The organization may be able to deduct otherwise nondeductible travel, meals, and entertainment expenses if the amounts are treated as compensation and reported on Form W-2 for an employee or Form 1099-MISC for an independent contractor.

Certain Expenses For Which Credits Are Allowable

For each of the credits listed below, the organization must reduce the otherwise allowable deductions for expenses used to figure the credit by the amount of the current year credit:

1. The credit for increasing research activities,
2. The enhanced oil recovery credit,
3. The disabled access credit,
4. The employer credit for social security and Medicare taxes paid on certain employee tips, and
5. The orphan drug credit.

If the organization has any of these credits, be sure to figure each current year credit before figuring the deduction for expenses on which the credit is based.

Business Startup Expenses

Business startup expenses must be capitalized unless an election is made to amortize them over a period of 60

months. See section 195 and Regulations section 1.195-1.

Line 16—Repairs and Maintenance

Enter the cost of incidental repairs and maintenance not claimed elsewhere on the return, such as labor and supplies, that do not add to the value or appreciably prolong the life of the property.

Line 17—Bad Debts

Enter the total receivables from unrelated business activities that were previously included in taxable income and that became worthless in whole or in part during the tax year.

Line 18—Interest

Attach a separate schedule listing the interest being claimed on this line.

• **Interest allocation.** If the proceeds of a loan were used for more than one purpose (e.g., to purchase a portfolio investment and to acquire an interest in a passive activity), an interest allocation must be made. See Temporary Regulations section 1.163-8T for the interest allocation rules.

• **Tax-exempt interest.** Do not include interest on indebtedness incurred or continued to purchase or carry obligations, on which the interest income is totally exempt from income tax. For exceptions, see section 265(b).

• **Prepaid interest.** Generally, a cash basis taxpayer cannot deduct prepaid interest allocable to years following the current tax year. For example, in 2001 a cash basis calendar year taxpayer prepaid interest on a loan. The taxpayer can deduct only that part of the prepaid interest that was for the use of the loan before January 1, 2002.

• **Straddle interest.** Generally, the interest and carrying charges on straddles cannot be deducted and must be capitalized. See section 263(g).

• **Original issue discount.** See section 163(e)(5) for special rules for the disqualified portion of original issue discount on a high yield discount obligation.

• **Related party interest.** Certain interest paid or accrued by the organization (directly or indirectly) to a related person may be limited if no tax is imposed on such interest. See section 163(j) for more details.

• **Interest allocable to the production of designated property.** Do not deduct interest on debt allocable to the production of designated property. Interest that is allocable to such property produced by an organization for its own use or for sale must be capitalized. An organization must also capitalize any interest on debt allocable to an asset used to produce the above property. See section 263A(f) and Regulations sections 1.263A-8 through 1.263A-15 for definitions and more information.

• **Interest on below-market loans.** See section 7872 for special rules regarding the deductibility of foregone interest on certain below-market-rate loans.

Line 19—Taxes and Licenses

Enter taxes and license fees paid or accrued during the year, but do not include the following:

- Federal income taxes.
- Foreign or U.S. possession income taxes if a tax credit is claimed. **Note:** For special rules on possession income taxes, see the Instructions for **Form 5735**, *Possessions Corporation Tax Credit (Under Sections 936 and 30A)*.
- Taxes not imposed on your organization.
- Taxes, including state or local sales taxes, paid or incurred in connection with an acquisition or disposition of property (these taxes must be treated as part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition).
- Taxes assessed against local benefits that increase the value of the property assessed (such as for paving, etc.).
- Taxes deducted elsewhere on the return, such as those reflected in cost of good sold.

See section 164(d) for apportionment of taxes on real property between the buyer and seller.

Line 20—Charitable Contributions

Enter contributions or gifts actually paid to another organization within the tax year to or for the use of charitable and governmental organizations described in section 170(c). Also, enter any unused contributions carried over from earlier years. The deduction for contributions will be allowed whether or not directly connected with the carrying on of a trade or business.

Contributions of property other than cash. If a contribution is in property other than cash and the deduction claimed for the property exceeds \$500, attach a schedule describing the kind of property contributed and the method used in determining its FMV. If the total claimed deduction for all property contributed was more than \$5,000, attach **Form 8283**, *Noncash Charitable Contributions*, to the return.

If the organization made a qualified conservation contribution under section 170(h), also include the FMV of the underlying property before and after the donation, the type of legal interest contributed, and describe the conservation purpose furthered by the donation.

If a contribution carryover is included, show the amount and how it was determined.

For special rules for certain contributions of ordinary income and capital gain property, see section 170(e).

If a charitable contribution deduction is taken for property sold to a charitable organization, the adjusted basis for determining gain from the sale is an amount that is in the same ratio to the adjusted basis as the amount realized is to the FMV of the property.

Corporations. The total amount claimed may not be more than 10% of unrelated business taxable income figured without regard to the deduction for charitable contributions.

Charitable contributions over the 10% limitation may not be deducted for the tax year, but may be carried over to the next 5 tax years.

In figuring the charitable contributions deduction, if the corporation has an NOL carryover to the tax year, the 10% limit is applied using the taxable income after taking into account any deduction for the NOL.

To figure the amount of any remaining NOL carryover to later years, taxable income must be modified. See section 172(b). To the extent charitable contributions are used to reduce taxable income for this purpose and increase a net operating loss carryover, a contributions carryover is not allowed. See section 170(d)(2)(B).

Corporations on the accrual basis may elect to deduct contributions paid by the 15th day of the 3rd month after the end of the tax year if the contributions are authorized by the board of directors during the tax year. Attach a declaration to the return, signed by an officer, stating that the resolution authorizing the contributions was adopted by the board of directors during the tax year. Also, attach a copy of the resolution.

Trusts. In general:

1. For contributions to organizations described in section 170(b)(1)(A), the amount claimed may not be more than 50% of the unrelated business taxable income figured without this deduction; and
2. For contributions to other organizations, the amount claimed may not be more than the smaller of:
 - a. 30% of unrelated business taxable income figured without this deduction; or
 - b. The amount by which 50% of the unrelated business taxable income is more than the contributions allowed in 1 above.



Contributions not allowable in whole or in part because of the limitations may not be deducted as a business expense, but may be carried over to the next 5 tax years.

Substantiation requirements.

Generally, no deduction is allowed for any contribution of \$250 or more, unless the organization gets a written acknowledgment from the charitable organization by the earlier of the due date (including extensions) for filing Form

990-T, or the date Form 990-T is filed. However, see section 170(f)(8) and the related regulations for exceptions to this rule. **Do not** attach the written acknowledgment to Form 990-T, but keep it with the organization's records.

The written acknowledgment must show:

1. The amount of cash contributed,
2. A description of any property contributed,
3. Whether the charitable organization provided any goods or services to the donor, and
4. A description and a good-faith estimate of the value of any goods and services provided to the donor in exchange for the donation, unless:
 - a. The goods and services have insubstantial value,
 - b. A statement is included that these goods and services consist solely of intangible religious benefits, or
 - c. Certain types of benefits are received that are customarily provided in exchange for membership payments of \$75 or less a year.

Generally, if your organization makes a charitable contribution of more than \$75 and receives something in return (a quid pro quo contribution), the amount of the contribution deductible for Federal income tax purposes is limited to the amount by which the contribution exceeds the value of the goods or services received. The charitable organization that solicits or receives the contribution must so inform you of this by written statement and must provide your organization with a good-faith estimate of the value of goods or services given in return for the contribution.

An organization must keep records, required by the regulations under section 170, for all its charitable contributions.

Contributions to organizations conducting lobbying activities.

Charitable contributions made to an organization conducting lobbying activities are not deductible if:

- The lobbying activities relate to matters of direct financial interest to the donor's trade or business, and
- The principal purpose of the contribution was to avoid Federal income tax by obtaining a deduction for activities that would have been nondeductible under the lobbying expense rules if conducted directly by the donor. See section 170(f)(9) for more details.

Contributions of computer technology and equipment to schools.

A corporation may take an increased deduction under section 170(e)(6) for qualified contributions of computer technology or equipment for educational purposes. A contribution is a qualified contribution if:

- It is made to an eligible donee (see below):

• Substantially all of the donee property's use is:

1. Related to the purpose or function of the donee;
 2. For use within the United States; and
 3. For educational purposes.
- The contribution is made not later than 3 years after the date the taxpayer acquired or substantially completed the construction of the property;
 - The original use of the property is by the donor or the donee;
 - The property is not transferred by the donee for money, services, or other property, except for shipping, transfer, and installation costs;
 - The property fits productively into the donee's education plan; and
 - The property meets standards, to be prescribed by regulations, to assure it meets minimum functionality and suitability for educational purposes.

Eligible donee. The term "eligible donee" means:

- An educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly conducted,
- A section 501(c)(3) entity organized primarily for purposes of supporting elementary and secondary education, or
- A public library (as described in section 170(e)(6)(B)(i)(III)).

Special rules. Qualified computer contributions may also include:

- Contributions of computer technology or equipment to private foundations (see section 170(e)(6)(C)) and
- Contributions of computers reacquired by the computer manufacturer (see section 170(e)(6)(D)).

Line 21—Depreciation

Besides depreciation, include on line 21 the part of the cost, under section 179, that the organization elected to expense for certain tangible property placed in service during tax year 2001 or carried over from 2000. See **Form 4562**, Depreciation and Amortization, and its instructions.

Line 23—Depletion

See sections 613 and 613A for percentage depletion rates for natural deposits. Attach **Form T**, Forest Activities Schedules, if a deduction is taken for depletion of timber.

Line 24—Contributions to Deferred Compensation Plans

Employers who maintain pension, profit-sharing, or other funded deferred compensation plans are generally required to file Form 5500. This requirement applies whether or not the plan is qualified under the Internal Revenue Code and whether or not a deduction is claimed for the current tax

year. Section 6652(e) imposes a penalty for late filing of these forms. In addition, there is a penalty for overstating the pension plan deduction. See section 6662(f).

Line 25—Employee Benefit Programs

Enter the amount of contributions to employee benefit programs (e.g., insurance, health and welfare programs) that are not an incidental part of a deferred compensation plan included on line 24.

Line 28—Other Deductions

Enter on this line the deduction taken for amortization (see Form 4562) as well as other authorized deductions for which no space is provided on the return. Attach a separate schedule listing the deductions claimed on this line. Deduct only items directly connected with the unrelated trade or business for which income is reported in Part I.

Do not deduct fines or penalties paid to a government for violating any law.

Line 31—Net Operating Loss (NOL) Deduction

The NOL deduction is the total of the net operating loss carryovers and carrybacks that can be deducted in the tax year. See section 172(a).

To be deductible, an NOL must have been incurred in an unrelated trade or business activity. The amount of an NOL carryback or carryover is determined under section 172. See Regulations section 1.512(b)-1(e). For more information about NOLs, see **Pub. 536**, Net Operating Losses.

Line 33—Specific Deduction

A specific deduction of \$1,000 is allowed except for computing the net operating loss and the net operating loss deduction under section 172.

Only one specific deduction may be taken, regardless of the number of unrelated businesses conducted. However, a diocese, province of a religious order, or convention or association of churches is allowed one specific deduction for each parish, individual church, district, or other local unit that regularly conducts an unrelated trade or business. This applies only to those parishes, districts, or other local units that are not separate legal entities, but are components of a larger entity (diocese, province, convention, or association). Each specific deduction will be the smaller of \$1,000 or the gross income from any unrelated trade or business the local unit conducts. If you claim a total specific deduction larger than \$1,000, attach a schedule showing how you figured the amount.

The diocese, province of a religious order, or convention or association of churches must file a return reporting the

gross income and deductions of all its units that are not separate legal entities. These local units cannot file separate returns because they are not separately incorporated. Local units that are separately incorporated must file their own returns and cannot be included with any other entity except for a title holding company. See the instructions under **Consolidated Returns** on page 5.

For details on the specific deduction, see section 512(b)(12) and the related regulations.

Part III—Tax Computation

Lines 35a and 35b

Corporate members of a controlled group, as defined in section 1563, must check the box on line 35 and complete lines 35a and 35b.

Members of a controlled group are entitled to one \$50,000, one \$25,000, and one \$9,925,000 taxable income bracket amount (in that order) on line 35a.

When a controlled group adopts or later amends an apportionment plan, each member must attach to its tax return a copy of its consent to this plan. The copy (or an attached statement) must show the part of the amount in each taxable income bracket apportioned to that member. See Regulations section 1.1561-3(b) for other requirements and for the time and manner of making the consent.

Equal apportionment plan. If no apportionment plan is adopted, members of a controlled group must divide the amount in each taxable income bracket equally among themselves. For example, Controlled Group AB consists of Corporation A and Corporation B. They do not elect an apportionment plan. Therefore, Corporation A and Corporation B are each entitled to \$25,000 (one-half of \$50,000) in the \$50,000 taxable income bracket on line 35a(1), \$12,500 (one-half of \$25,000) in the \$25,000 taxable income bracket on line 35a(2), and \$4,962,500 (one-half of \$9,925,000) in the \$9,925,000 taxable income bracket on line 35a(3).

Unequal apportionment plan. Members of a controlled group may elect an unequal apportionment plan and divide the taxable income brackets as they want. There is no need for consistency among taxable income brackets. Any member of the controlled group may be entitled to all, some, or none of the taxable income bracket. However, the total amount for all members of the controlled group cannot be more than the total amount in each taxable income bracket.

Additional 5% tax and additional 3% tax. Members of a controlled group are treated as one corporation to figure the applicability of the additional 5% tax that must be paid by corporations with taxable income over \$100,000 and the additional

3% tax that must be paid by corporations with taxable income over \$15 million. If either additional tax applies, each member of the controlled group will pay that tax based on the part of the amount that is used in each taxable income bracket to reduce that member's tax. See section 1561(a). Each member must enter its share of the additional 5% tax on line 35b(1) and its share of the additional 3% tax on line 35b(2) and attach to its tax return a schedule that shows the taxable income of the entire group, as well as how its share of the additional tax was figured.

Lines 35c and 36

Deferred tax amount under section 1291. If your organization has an excess distribution from a passive foreign investment company (PFIC) that is taxable as unrelated business taxable income, the organization may owe the deferred tax amount defined in section 1291(c)(1). The portion of the deferred tax amount that is the aggregate increases in taxes (described in section 1291(c)(2)) must be included in the amount entered on line 35c or 36. Write to the left of line 35c or 36, "Sec. 1291" and the amount. Do not include on line 35c or 36 the portion of the deferred tax amount that is the aggregate amount of interest determined under section 1291(c)(3). Instead, write "Sec. 1291 interest" and the amount in the bottom right margin of page 2, Form 990-T. See Part IV of **Form 8621**, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

Line 35c—Corporations

Use the Tax Rate Schedule for Corporations below to figure the tax. **Exception:** Members of a controlled group use the Tax Computation Worksheet for Members of a Controlled Group on this page to figure the tax. Members of a controlled group should see the instructions on page 12 for lines 35a and 35b. **Members of a controlled group must attach a statement showing the computation of the tax entered on line 35c.**

Tax Rate Schedule for Corporations (Internal Revenue Code – Section 11)

If the amount on line 34, page 1 is:		Enter on line 35c, page 2:	
Over—	But not over—	Tax is:	Of the amount over—
\$0	\$50,000	15%	\$0
50,000	75,000	\$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	-----	35%	0

Tax Computation Worksheet for Members of a Controlled Group (Keep for your records)

Each member of a controlled group must compute the tax using the computation below:

- Enter unrelated business taxable income (line 34, page 1, Form 990-T) _____
- Enter line 1 or corporation's share of the \$50,000 taxable income bracket, whichever is less _____
- Subtract line 2 from line 1 _____
- Enter line 3 or corporation's share of the \$25,000 taxable income bracket, whichever is less _____
- Subtract line 4 from line 3 _____
- Enter line 5 or corporation's share of the \$9,925,000 taxable income bracket, whichever is less _____
- Subtract line 6 from line 5 _____
- Enter 15% of line 2 _____
- Enter 25% of line 4 _____
- Enter 34% of line 6 _____
- Enter 35% of line 7 _____
- If the taxable income of the controlled group exceeds \$100,000, enter this member's share of the **smaller** of: (a) 5% of the excess over \$100,000, or (b) \$11,750. (See instructions for additional 5% and additional 3% tax.) _____
- If the taxable income of the controlled group exceeds \$15 million, enter this member's share of the **smaller** of: (a) 3% of the excess over \$15 million, or (b) \$100,000. (See instructions for additional 5% and additional 3% tax.) _____
- Add lines 8 through 13. Enter here and on line 35c, page 2, Form 990-T _____

Line 36—Trusts

Trusts exempt under section 501(a), which otherwise would be subject to subchapter J (estates, trusts, etc.), are taxed at trust rates. This rule also applies to employees' trusts that qualify under section 401(a). Most trusts figure the tax on the amount on line 34 using the Tax Rate Schedule for Trusts, below. If the tax rate schedule is used, enter the tax on line 36 and check the "tax rate schedule" box on line 36. If the trust is eligible for the rates on net capital gains, complete Schedule D (Form 1041) and enter the tax from Schedule D (Form 1041) on page 2, line 36. Check the "Schedule D" box on line 36 and attach Schedule D (Form 1041) to Form 990-T.

Tax Rate Schedule for Trusts (Internal Revenue Code – Section 1(e))

If the amount on line 34, page 1 is:		Enter on line 36, page 2:	
Over—	But not over—	Tax is:	Of the amount over—
\$0	\$1,800	15%	\$0
1,800	4,250	\$270.00 + 27.5%	1,800
4,250	6,500	943.75 + 30.5%	4,250
6,500	8,900	1,630.00 + 35.5%	6,500
8,900	----	2,482.00 + 39.1%	8,900

Line 37—Proxy Tax

To pay the section 6033(e)(2) proxy tax on nondeductible lobbying and political expenditures, enter the proxy tax on line

37 and attach a schedule showing the computation.

Exempt organizations, **except section 501(c)(3) and certain other organizations**, must include certain information regarding lobbying expenditures on Form 990. In addition, organizations may have to provide notices to members regarding their share of dues to which the expenditures are allocable. See Form 990 instructions and Rev. Proc. 95-35, 1995-2 C.B. 391 and Rev. Proc. 95-35A, 1995-2 C.B. 392 for exceptions and other details.

If the organization elects not to provide the notices described above, it must pay the proxy tax described in section 6033(e)(2). If the organization does not include the entire amount of allocable dues in the notices, it may have to pay the proxy tax. **This tax is not applicable to section 501(c)(3) organizations.** Figure the proxy tax by multiplying the aggregate amount not included in the notices described above by 35%. No deductions are allowed.

Line 38—Alternative Minimum Tax

Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax on certain adjustments and tax preference items. Trusts attach **Schedule I**, Alternative Minimum Tax, of Form 1041 and enter any tax from Schedule I on this line. A corporation, unless it is treated as a "small corporation" exempt from the alternative minimum tax, may have to attach **Form 4626**, Alternative Minimum Tax—Corporations, and enter any tax from Form 4626 on this line. See the Instructions for Form 4626 for the definition of a small corporation.

Part IV—Tax and Payments

Line 40a—Foreign Tax Credit

- Corporations.** See **Form 1118**, Foreign Tax Credit—Corporations, for an explanation of when a corporation can take this credit for payment of income tax to a foreign country or U.S. possession.
- Trusts.** See **Form 1116**, Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual), for rules on how the trust computes the foreign tax credit.

Complete the form that applies to the organization and attach the form to its Form 990-T. Enter the credit on this line.

Line 40b—Other Credits

- Possessions tax credit.** The Small Business Job Protection Act of 1996 repealed the possessions credit. However, existing claimants may qualify for a credit under the transitional rules. See the Instructions for Form 5735.

- **Nonconventional source fuel credit.** A credit is allowed for the sale of qualified fuels produced from a nonconventional source. Section 29 contains a definition of qualified fuels, provisions for figuring the credit, and other special rules. Attach a separate schedule to the return showing the computation of the credit. Also, see **Form 8801**, Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts, or **Form 8827**, Credit for Prior Year Minimum Tax—Corporations, if any of the 2000 nonconventional source fuel credit was disallowed solely because of the tentative minimum tax limitation. See section 53(d).

- **Qualified electric vehicle credit.** Include on line 40b any credit from **Form 8834**, Qualified Electric Vehicle Credit. Vehicles that qualify for this credit are not eligible for the deduction for clean-fuel vehicles under section 179A.

Line 40c—General Business Credit

Complete **Form 3800**, General Business Credit, if the organization has:

1. Two or more of the credits listed below; OR
2. A credit carryforward or carryback (including one from an ESOP credit); OR
3. A passive activity credit (other than the low-income housing credit); OR
4. General credits from an electing large partnership.

Enter the amount of the general business credit on line 40c and check the Form 3800 box on that line. Attach Form 3800 and the other applicable credit forms to Form 990-T.

Form 3800 is not required if the organization has only one of the general business credits (and items 2-4 above do not apply). Instead, attach the applicable credit form(s) to the return; check the "Form(s)" box; specify the form number(s) in the space provided, and include the amount of the credit(s) on line 40c.

For Form 990-T filers, the general business credit includes:

- Investment Credit, **Form 3468**.
- Credit for Alcohol Used as Fuel, **Form 6478**.
- Credit for Increasing Research Activities, **Form 6765**.
- Low-Income Housing Credit, **Form 8586**.
- Orphan Drug Credit, **Form 8820**.
- Disabled Access Credit, **Form 8826**.
- Enhanced Oil Recovery Credit, **Form 8830**.
- Renewable Electricity Production Credit, **Form 8835**.
- Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips, **Form 8846**.
- Credit for Contributions to Selected Community Development Corporations, **Form 8847**.
- New Markets Credit, **Form 8874**.

Line 40d—Credit for Prior Year Minimum Tax

Use Form 8801 to figure the minimum tax credit and any carryforward of that credit for trusts. For corporations, use Form 8827.

Line 42—Other Taxes

Recapture of investment credit. If property is disposed of, or ceases to be qualified property, before the end of the recapture period or the useful life applicable to the property, there may be a recapture of the credit. See **Form 4255**, Recapture of Investment Credit.

Recapture of low-income housing credit. If the organization disposed of property (or there was a reduction in the qualified basis of the property) for which it took the low-income housing credit, it may owe a tax. See **Form 8611**, Recapture of Low-Income Housing Credit, and section 42(j) for details.

Interest due under the look-back method. If the organization used the look-back method for certain long-term contracts, see Form 8697 for information on figuring the interest the organization may have to include.

The organization may also have to include interest due under the look-back method for property depreciated under the income forecast method. See **Form 8866**, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method.

Other. Additional taxes and interest amounts may be included in the total entered on line 42. Check the box for "Other" if the organization includes any of the taxes and interest discussed below. See **How to report**, below, for details on reporting these amounts on an attached schedule.

- Recapture of qualified electric vehicle (QEV) credit. The organization must recapture part of the QEV credit it claimed in a prior year if within 3 years of the date the vehicle was placed in service, it ceases to qualify for the credit. See Regulations section 1.30-1 for details on how to figure the recapture.
- Tax and interest on a nonqualified withdrawal from a capital construction fund (section 7518).
- Interest on deferred tax attributable to (a) installment sales of certain timeshares and residential lots (section 453(l)(3)) and (b) certain nondealer installment obligations (section 453A(c)).
- Interest due on deferred gain (section 1260(b)).

How to report. If the organization checked the "Other" box, attach a schedule showing the computation of each item included in the total for line 42. In addition, identify (a) the applicable Code section, (b) the type of tax or interest, and (c) enter the amount of tax or interest. For example, if the

organization is reporting \$100 of tax due from the recapture of the QEV credit, write "Section 30-QEV recapture tax-\$100" on the attached schedule.

Line 43—Total Tax

Include any deferred tax on the termination of a section 1294 election applicable to shareholders in a qualified electing fund in the amount entered on line 43. See Form 8621, Part V, and **How to report**, below.

Subtract from the total entered on line 43 any deferred tax on the corporation's share of undistributed earnings of a qualified electing fund (see Form 8621, Part II).

How to report. Attach a schedule showing the computation of each item included in, or subtracted from, the total on line 43. On the dotted line next to line 43, specify (a) the applicable Code section, (b) the type of tax, and (c) enter the amount of tax.

Line 44b—Estimated Tax

Enter the total estimated tax payments made for the tax year.

If an organization is the beneficiary of a trust, and the trust makes a section 643(g) election to credit its estimated tax payments to its beneficiaries, include the organization's share of the estimated tax payment in the total amount entered here. In the entry space to the left of line 44b, write "T" and the amount attributable to it.

Line 44d—Foreign Organizations

Enter the tax withheld on unrelated business taxable income from U.S. sources that is not effectively connected with the conduct of a trade or business within the United States. Attach **Form 1042-S**, Foreign Person's U.S. Source Income Subject to Withholding, or other form which verifies the tax withheld reported on line 44d.

Line 44e—Backup Withholding

Recipients of dividend or interest payments must generally certify their correct tax identification number to the bank or other payer on W-9. If the payer does not get this information, it must withhold part of the payments as "backup withholding." If your organization was subject to erroneous backup withholding because the payer did not realize you were an exempt organization and not subject to this withholding, you can claim credit for the amount withheld by including it on line 44e. See **Backup Withholding** under **Which Parts To Complete** on page 5.

Line 44f—Other Credits and Payments

Enter on this line the following:


- **Credit from regulated investment company (RIC) or real estate investment trust (REIT).** Attach Form

2439, Notice to Shareholder of Undistributed Long-Term Capital Gains. If you are filing a composite Form 990-T, see **Composite Form 990-T** under **Which Parts To Complete** on page 4 of these instructions.

• **Credit for ozone-depleting**

chemicals. Include on line 44f any credit the organization is claiming under section 4682(g) for taxes paid on chemicals used as propellants in metered-dose inhalers.

• **Credit for Federal tax paid on fuels.** Attach **Form 4136**, Credit for Federal Tax Paid on Fuels, if the organization qualifies to take this credit.

 **Form 8849**, Claim for Refund of Excise Taxes, may be used to claim a periodic refund of excise taxes instead of waiting to claim a credit on Form 4136. See the instructions for Form 8849 and **Pub. 378**, Fuel Tax Credits and Refunds, for more information.

Line 47—Tax Due

Domestic organizations owing less than \$500 and foreign organizations that **do not** have an office or place of business in the United States should enclose a check or money order (in U.S. funds), made payable to the United States Treasury, with Form 990-T.

Domestic organizations owing \$500 or more and foreign organizations with an office or place of business in the United States should see **Depository Method of Tax Payment** on page 3.

Part V—Statements Regarding Certain Activities and Other Information

Complete all items in Part V.

Line 1. Check “Yes” if either 1 or 2 below applies:

1. At any time during the year the organization had an interest in or signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account); AND

a. The combined value of the accounts was more than \$10,000 at any time during the year; AND

b. The accounts were NOT with a U.S. military banking facility operated by a U.S. financial institution.

2. The organization owns more than 50% of the stock in any corporation that would answer “Yes” to item 1 above.

If the “Yes” box is checked, write the name of the foreign country or countries. Attach a separate sheet if more space is needed.


Get **Form TD F 90-22.1**, Report of Foreign Bank and Financial Accounts, to see if the organization is considered to have an interest in or signature or other authority over a financial account in a

foreign country (such as a bank account, securities account, or other financial account). The organization can obtain Form TD F 90-22.1 from the IRS Forms Distribution Center or by calling 1-800-TAX-FORM (1-800-829-3676) or by downloading it from the IRS Web Site at www.irs.gov. If the organization is required to file this form, file it by June 30, 2002, with the Department of the Treasury at the address shown on the form. Do not file it with the IRS or attach it to Form 990-T.

Line 2. The organization may be required to file **Form 3520**, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, if:

- It directly or indirectly transferred money or property to a foreign trust. For this purpose, any U.S. person who created a foreign trust is considered a transferor.
- It is treated as the owner of any part of the assets of a foreign trust under the grantor trust rules.
- It received a distribution from a foreign trust.

For more information, see the instructions for Form 3520.

 An owner of a foreign trust must ensure that the trust files an **Form 3520-A**, Annual Information Return of Foreign Trust With a U.S. Owner. For details, see the Instructions for Form 3520-A.

Line 3. Report any tax-exempt interest received or accrued in the space provided. Include any exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company.

Signature

Corporations. The return must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or by any other corporate officer (such as tax officer) authorized to sign. Receivers, trustees, or assignees must also sign and date any return filed on behalf of the organization.


Trusts. The return must be signed and dated by the individual fiduciary, or by the authorized officer of the trust receiving or having custody or control and management of the income of the trust. If two or more individuals act jointly as fiduciaries, any one of them may sign.

Special rule for IRA trusts. A trustee of IRA trusts may use a facsimile signature if all of the following conditions are met:

- Each group of returns sent to the IRS must be accompanied by a letter signed by the person authorized to sign the returns declaring, under penalties of perjury, that the facsimile signature appearing on the returns is the signature adopted by that person to sign the returns filed and that the signature was affixed to

the returns by that person or at that person’s direction.

- The letter must also list each return by the name and EIN of the IRA trust.
- After the facsimile signature is affixed, no entries on the return may be altered other than to correct discernible arithmetic errors.
- A manually signed copy (of the letter submitted to the IRS with the returns and a record of any arithmetic errors corrected) must be retained on behalf of the IRA trusts listed in the letter and it must be available for inspection by the IRS.

 The above instructions regarding facsimile signatures **do not** apply to paid preparers.

Paid preparer. If an officer of the organization filled in its return, the paid preparer’s space should remain blank. Anyone who prepares the return but does not charge the organization should not sign the return. Certain others who prepare the return should not sign. For example, a regular, full-time employee of the organization, such as a clerk, secretary, etc., should not sign.

Generally, anyone who is paid to prepare the organization’s tax return must sign it and fill in the “Paid Preparer’s Use Only” area.

The **paid preparer** must complete the required preparer information:

- Sign the return, by hand, in the space provided for the preparer’s signature (signature stamps or labels are not acceptable).
- Give a copy of the return to the organization.

Paid Preparer Authorization. If the organization wants to allow the IRS to discuss its 2001 tax return with the paid preparer who signed it, check the “Yes” box in the signature area of the return. This authorization applies only to the individual whose signature appears in the “Paid Preparer’s Use Only” section of its return. It does not apply to the firm, if any, shown in that section.

If the “Yes” box is checked, the organization is authorizing the IRS to call the paid preparer to:

- Give the IRS any information that is missing from its return,
- Call the IRS for information about the processing of its return or the status of its refund or payment(s), and
- Respond to certain IRS notices that the organization has shared with the preparer about a math error, offsets, and return preparation. The notices will not be sent to the preparer.

The organization is not authorizing the paid preparer to receive any refund check, bind the organization to anything (including any additional tax liability), or otherwise represent the organization before the IRS. If the organization wants to expand the paid preparer’s

authorization, see **Pub. 947**, Practice Before the IRS and Power of Attorney.

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (excluding extensions) for filing the 2002 Form 990-T.

Schedule A—Cost of Goods Sold

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor. See Regulations section 1.471-1.

However, if the organization is a qualifying taxpayer, it may adopt or change its accounting method to account for inventory items in the same manner as materials and supplies that are not incidental. A **qualifying taxpayer** is a taxpayer **(a)** whose average annual gross receipts for the 3 prior tax years is \$1 million or less and **(b)** whose business is not a tax shelter (as defined in section 448(d)(3)).

Under this accounting method, inventory cost for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year the organization paid for the raw materials or merchandise if it is also using the cash method). Enter amounts paid for all raw materials and merchandise during the tax year on line 2. The amount the organization can deduct for the tax year is figured on line 7. For additional guidance on this method of accounting for inventory items, see Rev. Proc. 2001-10 and Pub. 538.

All filers not using the cash method of accounting should see Section 263A uniform capitalization rules in the instructions for **Limitations on Deductions** on page 9 before completing Schedule A. The instructions for lines 4a, 4b, and 6 below apply to Schedule A.

Inventory valuation methods.

Inventories can be valued at:

1. Cost as described in Regulations section 1.471-3,
2. Lower of cost or market as described in Regulations section 1.471-4, or
3. Any other method approved by the IRS that conforms to the requirements of the applicable regulations cited below.

However, if the organization chooses to account for inventory items as materials and supplies that are not incidental, it is required to use cost.

A small producer is one whose average annual gross receipts are \$1 million or less. Small producers that account for inventories in the same manner as materials and supplies that are

not incidental may currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs.

The average cost (rolling average) method of valuing inventories generally does not conform to the requirement of the regulations. See Rev. Rul. 71-234, 1971-1 C.B. 148.

Organizations that use erroneous valuation methods must change to a method permitted for Federal income tax purposes. To make this change, file Form 3115.

Inventory may be valued below cost when the merchandise is unsalable at normal prices, or unusable in the normal way because the goods are subnormal because of damage, imperfections, shop wear, etc., within the meaning of Regulations section 1.471-2(c). The goods may be valued at the current bona fide selling price, minus direct cost of disposition (but not less than scrap value) if such a price can be established.

If this is the first year the Last-in First-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach **Form 970**, Application To Use LIFO Inventory Method, or a statement with the information required by Form 970.

If the organization changed or extended its inventory method to LIFO and had to write up the opening inventory to cost in the year of election, report the effect of this write up as other income (line 12, page 1) proportionately over a 3-year period that begins in the tax year the LIFO election was made (section 472(d)).

Schedule A, line 1. If the organization is changing its method of accounting to no longer account for inventories, it must refigure last year's closing inventory using the new method of accounting and enter the result on line 1. If there is a difference between last year's closing inventory and the refigured amount, attach an explanation and take it into account when figuring the organization's section 481(a) adjustment (explained on page 6).

Schedule A, line 4a. An entry is required on this line only for organizations that have elected a simplified method of accounting.

For organizations that have elected the **simplified production method**, additional section 263A costs are generally those costs, other than interest, that are now required to be capitalized under section 263A but that were not capitalized under the organization's method of accounting immediately prior to the effective date of section 263A. For details, see Regulations section 1.263A-2(b).

For organizations that have elected the **simplified resale method**, additional section 263A costs are generally those costs incurred with respect to the following categories: off-site storage or warehousing; purchasing; handling, such as processing, assembling, repackaging and transporting; and general and administrative costs (mixed service costs). For details, see Regulations section 1.263A-3(d).

Enter on line 4a the balance of section 263A costs paid or incurred during the tax year not included on lines 2 and 3.

Schedule A, line 4b. Enter on line 4b any costs paid or incurred during the tax year not entered on lines 2 through 4a.

Schedule A, line 6. See Regulations sections 1.263A-1 through 3 for details on figuring the amount of additional section 263A costs to be included in ending inventory.

If the organization accounts for inventories in the same manner as materials and supplies that are not incidental, enter on line 6 the portion of its raw materials and merchandise purchased for resale that are included on line 5 and were not sold during the year.

Schedule C—Rent Income

Section 501(c)(7), (9), and (17) organizations, enter gross rents on Part I, line 6, and applicable expenses on Part II, lines 14 through 28. All rents except those that are exempt function income must be included.

All organizations that have applicable rent income, other than section 501(c)(7), (9), and (17) organizations, should complete Schedule C on page 3 of the return. For organizations other than section 501(c)(7), (9), and (17) organizations, only the following rents are taxable in Part I, line 6:

1. Rents from personal property leased with real property, if the rents from the personal property are more than 10% of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

2. Rents from real and personal property if:

a. More than 50% of the total rents received or accrued under the lease are for personal property; or

b. The amount of the rent depends on the income or profits derived by any person from the property leased (except an amount based on a fixed percentage of receipts or sales).

A redetermination of the percentage of rent for personal property is required when either:

1. There is an increase of 100% or more by the placing of additional or substitute personal property in service; or

2. There is a modification of the lease that changes the rent charged.

Rents from both real and personal property not taxable in Part I, line 6, may be taxable on line 8 if the income is from a controlled organization or on line 7 if the property is debt-financed. Taxability of the rents must be considered in that order; that is, rents not taxed on line 6 may be taxed on line 8 and rents not taxed on line 6 or line 8 may be taxed on line 7.


Rents from personal property that is not leased with real property should be reported on line 12 of Part I.

See Form 8582 (for trusts) or Form 8810 (for corporations) and section 469 for limitations on losses from rental activities.

Schedule E—Unrelated Debt-Financed Income

Schedule E applies to all organizations except sections 501(c)(7), (9), and (17) organizations.

When debt-financed property is held for exempt purposes and other purposes, the organization must allocate the basis, debt, income, and deductions among the purposes for which the property is held. Do not include in Schedule E amounts allocated to exempt purposes.

 For section 514 purposes, **do not treat an interest in a qualified state tuition program (QSTP) as debt.** However, a QSTP's investment income is treated as debt-financed income if the QSTP incurs indebtedness when acquiring or improving income-producing property.

Column 1—Description of debt-financed property. Any property held to produce income is debt-financed property if at any time during the tax year there was acquisition indebtedness outstanding for the property. When any property held for the production of income by an organization is disposed of at a gain during the tax year, and there was acquisition indebtedness outstanding for that property at any time during the 12-month period before the date of disposition, the property is debt-financed property. Securities purchased on margin are considered debt-financed property if the liability incurred in purchasing them remains outstanding.

Acquisition indebtedness is the outstanding amount of principal debt incurred by the organization to acquire or improve the property:

1. Before the property was acquired or improved, if the debt was incurred because of the acquisition or improvement of the property; or
2. After the property was acquired or improved, if the debt was incurred because of the acquisition or improvement, and the organization could reasonably foresee the need to incur the debt at the time the property was acquired or improved.

With certain exceptions, acquisition indebtedness does not include debt incurred by:

1. A qualified (section 401) trust in acquiring or improving real property. See section 514(c)(9) for more details.
2. A tax-exempt school (section 170(b)(1)(A)(ii)) and its affiliated support organizations (section 509(a)(3)) for indebtedness incurred after July 18, 1984.
3. An organization described in section 501(c)(25) in tax years beginning after December 31, 1986.

See Pub. 598 for additional exceptions to the rules for debt-financed property.

Column 2. Income is not unrelated debt-financed income if it is otherwise included in unrelated business taxable income. For example, do not include rents from personal property shown in Schedule C, or rents and interest from controlled organizations shown in Schedule F.

Column 4. Average acquisition indebtedness for any tax year is the average amount of the outstanding principal debt during the part of the tax year the property is held by the organization. To figure the average amount of acquisition debt, determine the amount of the outstanding principal debt on the first day of each calendar month during that part of the tax year that the organization holds the property. Add these amounts together, and divide the result by the total number of months during the tax year that the organization held the property. See section 514(a) and the related regulations for property acquired for an indeterminate price.

Column 5. The average adjusted basis for debt-financed property is the average of the adjusted basis of the property on the first and last days during the tax year that the organization holds the property. Determine the adjusted basis of property under section 1011. Adjust the basis of the property by the depreciation for all earlier tax years, whether or not the organization was exempt from tax for any of these years. Similarly, for tax years during which the organization is subject to tax on unrelated business taxable income, adjust the basis of the property by the entire amount of allowable depreciation, even though only a part of the deduction for depreciation is taken into account in figuring unrelated business taxable income.

If no adjustments to the basis of property under section 1011 apply, the basis of the property is cost.

See section 514(d) and the related regulations for the basis of debt-financed property acquired in a complete or partial liquidation of a corporation in exchange for its stock.

Column 7. The amount of income from debt-financed property included in unrelated trade or business income is

figured by multiplying the property's gross income by the percentage obtained from dividing the property's average acquisition indebtedness for the tax year by the property's average adjusted basis during the period it is held in the tax year. This percentage cannot be more than 100%.

Column 8. For each debt-financed property, deduct the same percentage (as determined above) of the total deductions that are directly connected to the income (including the dividends-received deductions allowed by sections 243, 244, and 245). However, if the debt-financed property is depreciable property, figure the depreciation deduction by the straight line method only, and enter the amount in column 3(a).

For each debt-financed property, attach schedules showing separately a computation of the depreciation deduction (if any) reported in column 3(a) and a breakdown of the expenses included in column 3(b). Corporations owning stock that is unrelated debt-financed property should see Schedule C (Dividends and Special Deductions) of **Form 1120**, U.S. Corporation Income Tax Return, to determine the dividends-received deductions to include in column 3(b).

Enter on the last line of Schedule E, the total dividends-received deductions (after reduction, when applicable, by the debt-basis percentage(s)) included in column 8.

When a capital loss for the tax year may be carried back or carried over to another tax year, the amount to carry over or back is figured by using the percentage determined above. However, in the year to which the amounts are carried, do not apply the debt-basis percentage to determine the deduction for that year.

Example 1. An exempt organization owns a four-story building. Two floors are used for an exempt purpose and two floors are rented (as an unrelated trade or business) for \$10,000. Expenses are \$1,000 for depreciation and \$5,000 for other expenses that relate to the entire building. The average acquisition indebtedness is \$6,000, and the average adjusted basis is \$10,000. Both apply to the entire building.

To complete Schedule E for this example, describe the property in column 1. Enter \$10,000 in column 2 (since the entire amount is for debt-financed property), \$500 and \$2,500 in columns 3(a) and 3(b), respectively (since only one-half of the expenses are for the debt-financed property), \$3,000 and \$5,000 in columns 4 and 5, respectively (since only one-half of the acquisition indebtedness and the average adjusted basis are for debt-financed property), 60% in column 6, \$6,000 in column 7, and \$1,800 in column 8.

Example 2. Assume the same facts as in *Example 1*, except the entire building is rented out as an unrelated

trade or business for \$20,000. To complete Schedule E for this example, enter \$20,000 in column 2, \$1,000 and \$5,000 in columns 3(a) and 3(b), respectively (since the entire amount is for debt-financed property), \$6,000 and \$10,000 in columns 4 and 5 (since the entire amount is for debt-financed property), 60% in column 6, \$12,000 in column 7, and \$3,600 in column 8.

Schedule F—Interest, Annuities, Royalties, and Rents From Controlled Organizations

Interest, annuities, royalties, and rents received or accrued (directly or indirectly) by a controlling organization from a controlled organization are subject to tax, whether or not the activity conducted by the controlling organization to earn these amounts is a trade or business or is regularly carried on.

Controlled Organization

An entity is a “controlled organization” if the controlling organization owns:

- By vote or value more than 50% of a corporation’s stock (for an organization that is a corporation);
- More than 50% of a partnership’s profits or capital interests (for an organization that is a partnership); or
- More than 50% of the beneficial interests in an organization (for an organization other than a corporation or partnership).

To determine the ownership of stock in a corporation, apply the principles of section 318 (constructive ownership of stock). Apply similar principles to determine the ownership of interests in a partnership or any other organization.

Specified payment means any payment of interest, annuity, royalty, or rent. Include the specified payment in gross income to the extent that the payment reduces the *net unrelated income* (or increases the *net unrelated loss*) of the controlled organization.

If any part of a specified payment is included in gross income, Schedule F must be completed.

Net unrelated income means:

- For a controlled organization that **is exempt** from tax under section 501(a), the unrelated business taxable income of the controlled organization.
- For a controlled organization that **is not exempt** from tax under section 501(a), the part of the controlled organization’s taxable income that would be unrelated business taxable income if the controlled organization was tax exempt under section 501(a) and had the same tax-exempt purpose as the controlling organization.

Net unrelated loss means the net operating loss using rules similar to those discussed under **Net unrelated income**.

Schedule G—Investment Income of a Section 501(c)(7), (9), or (17) Organization

Generally, for section 501(c)(7), (9), or (17) organizations, unrelated trade or business income includes all gross income from nonmembers with certain modifications. See section 512(a)(3)(A). Report on Schedule G all income from investments in securities and other similar investment income from nonmembers, including 100% of income and directly connected expenses from debt-financed property. Do not report nonmember income from debt-financed property on Schedule E.

All section 501(c)(7), (9), and (17) organizations figure their investment income using Schedule G. Do not include interest on state and local governmental obligations described in section 103(a).

Investment income includes all income from debt-financed property whether or not the income is subject to unrelated business income tax.

Deduct only those expenses that are directly connected to the net investment income. Allocate deductions between exempt activities and other activities where necessary. The organization may not take the dividends-received deductions in figuring net investment income because they are not treated as directly connected with the production of gross income.

Section 501(c)(7), (9), and (17) organizations may set aside income that would otherwise be taxable under section 512(a)(3). However, income derived from an unrelated trade or business may not be set aside and thus cannot be exempt function income. In addition, any income set aside and later expended for other purposes must be included in income.

Sections 501(c)(7), (9), and (17) organizations will not be taxed on income set aside for:

1. Religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals;
2. The payment of life, sick, accident, or other benefits by a section 501(c)(9) or (17) organization. The amount allowed as a set aside may not exceed a limit determined using section 419A. See sections 419A and 512(a)(3)(E) for details;
3. Reasonable administration costs directly connected with 1 and 2 above.

Report income set aside in column 4 of Schedule G. Amounts set aside are not

deductible under section 170 or any other section of the Code.

The organization may elect to treat income set aside by the date for filing the return, including any extensions of time, as income set aside in the tax year for which the return is filed. The income set aside must have been includable in gross income for that earlier tax year.

Although set aside income may be accumulated, any accumulation that is unreasonable will be evidence that the set aside was not for the purposes described above.

Net investment income set aside must be specifically earmarked as such, or placed in a separate account or fund (except for an employees’ association which, by the terms of its governing instrument, must use its net investment income for the purposes stated in 2 above).

These rules apply to a corporation described in section 501(c)(2) (title holding corporation) whose income is payable to an organization described in section 501(c)(7), (9), or (17) if it files a consolidated return with the section 501(c)(7), (9), or (17) organization.

If a section 501(c)(7), (9), or (17) organization (or a title holding corporation described above) sells property that was used for the exempt function of the section 501(c)(7), (9), or (17) organization, and buys other property used for the organization’s exempt function within a period beginning 1 year before the date of the sale, and ending 3 years after the date of the sale, the gain from the sale will be recognized only to the extent that the sales price of the old property is more than the cost of the other property. The other property need not be similar in type or use to the old property. The organization must notify the IRS of the sale by a statement attached to the return, or other written notice.

To compute the gain on the sale of depreciable property, see the instructions for column 5 of Schedule E to determine the adjusted basis of the property.

Schedule I—Exploited Exempt Activity Income, Other Than Advertising Income

A section 501(c)(7), (9), or (17) organization does not report exploited exempt activity income in Schedule I. Report the income in Part I, line 1a instead, or the appropriate line for the particular kind of income.

Exempt organizations (other than section 501(c)(7), (9), or (17) organizations) that have gross income from an unrelated trade or business activity that exploits an exempt activity (other than advertising income) should

complete Schedule I. See Regulations section 1.513-1(d)(4)(iv) for a definition of exploited exempt activity.

An organization may take all deductions directly connected with the gross income from the unrelated trade or business activity. In addition, the organization may take into account all deductible items attributable to the exploited exempt activity, with the following limitations:

1. Reduce the deductible items of the exempt activity by the income from the activity;
2. Limit the net amount of deductible items arrived at in 1 above for the exempt activity to the net unrelated business income from the exploited exempt activity;
3. Exclude income and expenses of the exempt activity in figuring a loss carryover or carryback from the unrelated trade or business activity exploiting the exempt activity; and
4. Exclude deductible items of the exempt activity in figuring unrelated trade or business income from an activity that is not exploiting the same exempt activity.

Therefore, the net includible exploited exempt activity income is the unrelated business taxable income minus the excess of the exempt activity expenses over the exempt activity income. If the income from the exempt activity exceeds the exempt activity expenses, do not add that profit to the net income from the unrelated business activity. If two or more unrelated trade or business activities exploit the same exempt activity, treat those activities as one on Schedule I. Attach a separate schedule showing the computation.

Schedule J—Advertising Income

A section 501(c)(7), (9), or (17) organization does not report advertising income on Schedule J. Instead, report that income in Part I, line 1a.

An exempt organization (other than a section 501(c)(7), (9), or (17) organization) that earned gross income from the sale of advertising in an exempt organization periodical must complete Schedule J. The part of the advertising income taken into account is determined as follows:

1. If direct advertising costs (expenses directly connected with advertising income) are more than advertising income (unrelated business income), deduct that excess in figuring unrelated business taxable income from any other unrelated trade or business activity carried on by the organization.

2. If advertising income is more than direct advertising costs, and circulation income (exempt activity income) equals or exceeds readership costs (exempt activity expenses), then unrelated business taxable income is the excess of advertising income over direct advertising costs.

3. If advertising income is more than direct advertising costs, and readership costs are more than circulation income, then unrelated business taxable income is the excess of total income (advertising income and circulation income) over total periodical costs (direct advertising costs and readership costs).

4. If the readership costs are more than the circulation income, and the net readership costs are more than the excess of advertising income over direct advertising costs, no loss is allowable. See Regulations section 1.512(a)-1(f)(2)(ii)(b).

For allocating membership receipts to circulation income, see Rev. Rul. 81-101, 1981-1 C.B. 352.

Consolidated periodicals. If an organization publishes two or more periodicals, it may elect to treat the gross income for all (but not less than all) periodicals, and deductions directly connected with those periodicals (including excess readership costs), as if the periodicals were one to determine its unrelated business taxable income. This rule only applies to periodicals published for the production of income. A periodical is considered published for the production of income if gross advertising income of the periodical is at least 25% of the readership costs, and the periodical is an activity engaged in for profit.

Schedule K— Compensation of Officers, Directors, and Trustees

Complete columns 1 through 4, Schedule K, for those officers, directors, and trustees whose salaries or other compensation are allocable to unrelated business gross income. Do not include in column 4 compensation that is deducted on lines 15, 28, or Schedules A through J of Form 990-T.

Include on Schedule K (or elsewhere on the return) only compensation that is directly attributable to the unrelated trade or business activities of the organization. If personnel is used both to carry on exempt activities and to conduct unrelated trade or business activities, the salaries and wages of those individuals will be allocated between the activities.

For example, assume an exempt organization derives gross income from the conduct of certain unrelated trade or business activities. The organization pays its president a salary of \$65,000 a year. Ten percent of the president's time is devoted to the unrelated business activity. On Form 990-T, the organization enters \$6,500 (10% of \$65,000) on Schedule K for the part of the president's salary allocable to the unrelated trade or business activity. However, the remaining \$58,500 (90% of \$65,000) cannot be deducted on Form 990-T because it is not directly attributable to the organization's unrelated trade or business activities.

If taxable fringe benefits are provided to your employees, such as personal use of a car, do not deduct as salaries and wages the amounts you deducted for depreciation and other deductions.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping	66 hr., 28 min.
Learning about the law or the form	25 hr., 41 min.
Preparing the form	41 hr., 51 min.
Copying, assembling, and sending the form to the IRS	4 hr., 1 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the Form 990-T to this address. Instead, see **Where To File** on page 3.

Codes for Unrelated Business Activity

(If engaged in more than one unrelated business activity, select up to two codes for the principal activities.
List first the largest in terms of unrelated income, then the next largest.)

<p>AGRICULTURE, FORESTRY, HUNTING, AND FISHING</p> <p>Code 110000 Agricultural, forestry, hunting, and fishing 111000 Crop production</p>	<p>485000 Transit and ground passenger transportation 485510 Charter bus industry 487000 Scenic and sightseeing transportation 493000 Warehousing and storage</p>	<p>561450 Credit bureaus 561499 All other business support services 561500 Travel arrangement and reservation services 561520 Tour operators 561700 Services to buildings and dwellings 562000 Waste management and remediation services</p>
<p>MINING</p> <p>Code 211110 Oil and gas extraction 212000 Mining (except oil and gas)</p>	<p>INFORMATION</p> <p>Code 511110 Newspaper publishers 511120 Periodical publishers 511130 Book publishers 511190 Other publishers 512000 Motion picture and sound recording industries 513100 Radio and television broadcasting 513300 Telecommunications 514000 Information services and data processing services</p>	<p>EDUCATIONAL SERVICES</p> <p>Code 611110 Elementary and secondary schools 611310 Colleges, universities, and professional schools 611510 Technical and trade schools 611600 Other schools and instruction</p>
<p>UTILITIES</p> <p>Code 221000 Utilities</p>	<p>FINANCE AND INSURANCE</p> <p>Code 522110 Commercial banking 522120 Savings institutions 522130 Credit unions 522190 Other depository credit intermediation 522210 Credit card issuing 522290 Other non-depository credit intermediation 523100 Securities, commodity contracts, and other intermediation and brokerage 524113 Direct life insurance carriers 524114 Direct health and medical insurance carriers 524121 Property and casualty insurance carriers 524126 Direct property and casualty insurance carriers 524130 Reinsurance carriers 524292 Third party administration for insurance and pension funds 524298 All other insurance related activities 525100 Insurance and employee benefit funds 525920 Trusts, estates, and agency accounts 525990 Other financial vehicles</p>	<p>HEALTHCARE AND SOCIAL ASSISTANCE</p> <p>Code 621000 Ambulatory health care services 621110 Offices of physicians 621210 Offices of dentists 621300 Offices of other health practitioners 621400 Outpatient care centers 621410 Family planning centers 621500 Medical and diagnostic laboratories 621610 Home health care services 621910 Ambulance services 621990 All other ambulatory health care services 621991 Blood and organ banks 622000 Hospitals 623000 Nursing and residential care facilities 623990 Other residential care facilities 624000 Social assistance 624100 Individual and family services 624200 Community food and housing, and emergency and other relief services 624310 Vocational rehabilitation services 624410 Child day care services</p>
<p>CONSTRUCTION</p> <p>Code 230000 Construction 233000 Building, developing, and general contracting</p>	<p>REAL ESTATE AND RENTAL AND LEASING</p> <p>Code 531110 Lessors of residential buildings and dwellings 531120 Lessors of nonresidential buildings, except miniwarehouses 531190 Lessors of other real estate property 531210 Offices of real estate agents and brokers 531310 Real estate property managers 531390 Other activities related to real estate 532000 Rental and leasing services 532291 Home health equipment rental 532420 Office machinery and equipment rental and leasing 533110 Lessors of nonfinancial intangible assets (except copyrighted works)</p>	<p>ARTS, ENTERTAINMENT, AND RECREATION</p> <p>Code 711110 Theater companies and dinner theaters 711120 Dance companies 711130 Musical groups and artists 711190 Other performing arts companies 711210 Spectator sports (including sports clubs and racetracks) 711300 Promoters of performing arts, sports, and similar events 712100 Museums, historical sites, and similar institutions 713110 Amusement and theme parks 713200 Gambling industries 713900 Other amusement and recreation industries (including golf courses, skiing facilities, marinas, fitness centers, and bowling centers)</p>
<p>MANUFACTURING</p> <p>Code 311000 Food manufacturing 312100 Beverage manufacturing 312200 Tobacco manufacturing 313000 Textile mills 315000 Apparel manufacturing 316000 Leather and allied product manufacturing 321000 Wood product manufacturing, except furniture 322000 Paper manufacturing 323100 Printing and related support activities 323117 Book printing 323119 Other commercial printing 324110 Petroleum refineries 325000 Chemical manufacturing 325200 Resin, synthetic rubber, artificial and synthetic fiber and filament manufacturing 327000 Nonmetallic mineral product manufacturing 331000 Primary metal manufacturing 332000 Fabricated metal product manufacturing 333000 Machinery manufacturing 334000 Computer and electronic product manufacturing 335000 Electrical equipment, appliance, and component manufacturing 336000 Transportation equipment manufacturing 337000 Furniture and related product manufacturing 339000 Miscellaneous manufacturing 339110 Medical equipment and supplies manufacturing</p>	<p>PROFESSIONAL, SCIENTIFIC, AND TECHNICAL SERVICES</p> <p>Code 541100 Legal services 541200 Accounting, tax preparation, bookkeeping, and payroll services 541300 Architectural, engineering, and related services 541380 Testing laboratories 541500 Computer systems design and related services 541511 Custom computer programming services 541610 Management consulting services 541700 Scientific research and development services 541800 Advertising and related services 541860 Direct mail advertising 541900 Other professional, scientific, and technical services</p>	<p>ACCOMMODATION AND FOOD SERVICES</p> <p>Code 721000 Accommodation 721110 Hotels (except casino hotels) and motels 721210 RV (recreational vehicle) parks and recreational camps 721310 Rooming and boarding houses 722100 Full-service restaurants 722210 Limited-service eating places 722320 Caterers 722410 Drinking places (alcoholic beverages)</p>
<p>WHOLESALE TRADE</p> <p>Code 421000 Wholesale trade, durable goods 422000 Wholesale trade, nondurable goods</p>	<p>MANAGEMENT OF COMPANIES AND ENTERPRISES</p> <p>Code 551111 Offices of bank holding companies 551112 Offices of other holding companies</p>	<p>OTHER SERVICES</p> <p>Code 811000 Repair and maintenance 812300 Drycleaning and laundry services 812900 Other personal services 812930 Parking lots and garages</p>
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<p>TRANSPORTATION AND WAREHOUSING</p> <p>Code 481000 Air transportation 482110 Rail transportation 483000 Water transportation 484000 Truck transportation</p>		



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Tax on Unrelated Business Income of Exempt Organizations



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Important Changes

Dues received by agricultural and horticultural organizations. Generally, for 2000, annual membership dues of not more than \$112 received from an associate member by a tax-exempt agricultural or horticultural organization are exempt from the tax on unrelated business income. See *Dues of Agricultural Organizations and Business Leagues* in chapter 4.

New electronic deposit requirement. Beginning January 1, 2000, the threshold that determines whether you must use the Electronic Federal Tax Payment System (EFTPS) to deposit federal taxes, including the unrelated business income tax, has been increased from \$50,000 to \$200,000. See *Tax Deposit Methods* in chapter 2.

Introduction

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

However, if an exempt organization regularly carries on a trade or business that is not substantially related to its exempt purpose, except that it provides funds to carry out that purpose, the organization is subject to tax on its income from that unrelated trade or business.

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

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

All section references in this publication

are to the Internal Revenue Code.

Useful Items

You may want to see:

Publication

- 557** Tax-Exempt Status for Your Organization

Form (and Instructions)

- 990-T** Exempt Organization Business Income Tax Return

See chapter 5 for information about getting these publications and forms.

1. Organizations Subject to the Tax

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

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

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

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

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

The tax is on the unrelated business income of both the universities and colleges

themselves and on their wholly owned subsidiary organizations that are tax exempt. It is immaterial whether the business is conducted by the university or by a separately incorporated wholly owned subsidiary. If the business activity is unrelated, the income in both instances will be subject to the tax. If the primary purpose of a wholly owned subsidiary is to operate or carry on any unrelated trade or business (other than holding title to property and collecting income from it), the subsidiary is not an exempt organization and this rule does not apply.

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

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

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

2. The Tax and Filing Requirements

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

The tax is imposed on the organization's unrelated business taxable income (described in chapter 4). The tax is reduced by any applicable tax credits, including the general business credits (such as the investment credit and the alcohol fuel credit) and the foreign tax credit.

Alternative minimum tax. Organizations liable for tax on unrelated business income may be liable for alternative minimum tax on certain adjustments and tax preference items.

Returns and Filing Requirements

An exempt organization subject to the tax on unrelated business income must file **Form 990-T** and attach any required supporting schedules and forms. The obligation to file Form 990-T is in addition to the obligation to file any other required returns.

Form 990-T is required if the organization's gross income from unrelated businesses is \$1,000 or more. An exempt organization must report income from all its unrelated businesses on a single Form 990-T. Each organization must file a separate Form 990-T, except section 501(c)(2) title holding corporations and organizations receiving their earnings that file a consolidated return under section 1501.

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

Where to file. Form 990-T must be filed with the Internal Revenue Service, Ogden, UT 84201-0027.

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

Extension of time to file. A corporation may request an automatic 6-month extension of time to file a return by submitting Form 7004, *Application for Automatic Extension of Time To File Corporation Income Tax Return*.

A trust may request an extension of time to file a return by submitting Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information, and Other Returns*. Trusts are not granted automatic extensions of time to file.

Public inspection of return. Unlike information returns filed by exempt organizations, Form 990-T is not available for public inspection.

Payment of Tax

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

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

All tax-exempt organizations should use Form 990-W (Worksheet), *Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations*, to figure their estimated tax.

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

Tax Deposit Methods

An exempt organization must deposit its unrelated business income tax (including estimated tax) using one of the following methods.

Electronic deposits. Some organizations are required to electronically deposit all depository taxes under section 6302, including the unrelated business income tax, using the Electronic Federal Tax Payment System (EFTPS). If the organization is required to deposit electronically and does not do so, it may be subject to a 10% penalty. Organizations that are not required to make electronic deposits may voluntarily participate in EFTPS. To enroll in EFTPS, call 1-800-555-4477 or 1-800-945-8400. For general information about EFTPS, see section 11 of Publication 15, *Circular E, Employer's Tax Guide*, or call 1-800-829-1040.

Electronic deposit requirement. If an organization deposits more than \$200,000 in depository taxes in a calendar year, it must electronically deposit all its depository tax liabilities for return periods beginning after the following calendar year. For example, an organization that deposited more than \$200,000 in 1998 must deposit all its depository tax liabilities for return periods beginning in 2000 and later years.

Deposits with Form 8109. If the organization is not required to (or does not voluntarily) make electronic deposits, it must make its deposits with Form 8109, *Federal Tax Deposit Coupon*.

The completed Form 8109 with the payment must be mailed or delivered to an authorized depository (financial institution) for federal taxes, as instructed on the coupon.

Deposits should not be sent directly to the IRS. A penalty may be imposed if the deposits are sent to an IRS office rather than to an authorized depository.

3.

Unrelated Trade or Business

Unrelated business income is the income from a **trade or business** that is **regularly carried on** by an exempt organization and that is **not substantially related** to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity.

Certain trade or business activities are not treated as an unrelated trade or business. See *Excluded Trade or Business Activities*, later.

Trade or business. The term "trade or business" generally includes any activity carried on for the production of income from selling goods or performing services. An activity does not lose its identity as a trade or business merely because it is carried on within a larger group of similar activities that may, or may not, be related to the exempt purposes of the organization.

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

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

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

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

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. For example, to the extent an activity is conducted on

a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. The part of the activity that is more than needed to accomplish the exempt purpose is an unrelated trade or business.

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

Selling of products of exempt functions. Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it is in when the exempt functions are completed. Thus, for an exempt organization engaged in rehabilitating handicapped persons (its exempt function), selling articles made by these persons as part of their rehabilitation training is not an unrelated trade or business.

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

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

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

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

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

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

Examples

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

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

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

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

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

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

Book publishing. An exempt organization engages primarily in activities that further its exempt purposes. It also owns the publication rights to a book that does not relate to any of its exempt purposes. The organization exploits the book in a commercial manner by arranging for printing, distribution, publicity, and advertising in connection with the sale of the book. These activities constitute a trade or business regularly carried on. Because exploiting the book is unrelated to the organization's exempt purposes (except for the use of the book's profits), the income is unrelated business income.

However, if the organization transfers publication rights to a commercial publisher in return for royalties, the royalty income received will not be unrelated business income. See *Royalties* under *Exclusions* in chapter 4.

School handicraft shop. An exempt vocational school operates a handicraft shop that sells articles made by students in their regular courses of instruction. The students are paid a percentage of the sales price. In addition, the shop sells products made by local residents who make articles at home according to the shop's specifications. The shop manager periodically inspects the articles during their manufacture to ensure that they meet desired standards of style and quality. Although many local participants are former students of the school, any qualified person may participate in the program. The sale of articles made by students does not constitute an unrelated trade or business, but the sale of products made by local residents is an unrelated trade or business and is subject to unrelated business income tax.

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

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

In both situations, the exempt purpose is the advancement of education. Furnishing tennis facilities in the manner described does not further that exempt purpose. These activities are unrelated trades or businesses. However, in the second situation the income derived from the leasing of the property is **excluded** from unrelated business taxable income as rent from real property. See *Rents* under *Exclusions* in chapter 4.

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

Leasing of the stadium is an unrelated trade or business. In addition, the substantial services furnished for the convenience of the lessee go beyond those usually provided with the rental of space for occupancy only. Therefore, the income from this lease is **not** excluded from unrelated business taxable income as rent from real property.

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

The educational purposes served by intercollegiate athletics are identical whether conducted directly by individual universities or by their regional athletic conference. Also, the educational purposes served by exhibiting a game before an audience that is physically present and exhibiting the game on television or radio before a much larger audience are substantially similar. Therefore, the sale of the

broadcasting rights contributes importantly to the accomplishment of the organization's exempt purpose and is not an unrelated trade or business.

In a similar situation, an exempt organization was created as a national governing body for amateur athletes to foster interest in amateur sports and to encourage widespread public participation. The organization receives income each year from the sale of exclusive broadcasting rights to an independent producer, who contracts with a commercial network to broadcast many of the athletic events sponsored, supervised, and regulated by the organization.

The broadcasting of these events promotes the various amateur sports, fosters widespread public interest in the benefits of the organization's nationwide amateur program, and encourages public participation. The sale of the rights and the broadcasting of the events contribute importantly to the organization's exempt purpose. Therefore, the sale of the exclusive broadcasting rights is not an unrelated trade or business.

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

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

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

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

Travel tour programs. Travel tour activities that are a trade or business are an unrelated trade or business if the activities are not substantially related to the purpose for which

tax exemption was granted to the organization.

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

The organization provides an employee for each tour as a tour leader. There is no formal educational program conducted with these tours, and they do not differ from regular commercially operated tours.

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

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

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

Exceptions. Organizations whose exempt activities may include the provision of insurance benefits, such as fraternal beneficiary societies, voluntary employees beneficiary associations, and labor organizations, are generally exceptions to this rule.

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

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

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

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

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

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

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

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

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

- 1) The normal manner in which the publication is circulated,
- 2) The territorial scope of the circulation,
- 3) The extent to which its readers, promoters, or the like could reasonably be expected to further, either directly or indirectly, the commercial interest of the advertisers,

- 4) The eligibility of the publishing organization to receive tax-deductible contributions, and
- 5) The commercial or noncommercial methods used to solicit the advertisers.

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

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

The publication of ordinary commercial advertising does not advance the exempt purposes of the association even when published in a periodical that contains material related to exempt purposes. Although the advertising is directed specifically to members of the legal profession, it is still commercial in nature and does not contribute importantly to the exempt purposes of the association. Therefore, the advertising income is unrelated trade or business income.

On the other hand, the publication of legal notices is distinguishable from ordinary commercial advertising in that its purpose is to inform the general public of significant legal events rather than to stimulate demand for the products or services of an advertiser. This promotes the common interests of the legal profession and contributes importantly to the association's exempt purposes. Therefore, the publishing of legal notices does not constitute an unrelated trade or business.

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

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

The museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards with printed reproductions of artworks contributes importantly to the achievement of the museum's exempt educational purposes by enhancing public awareness, interest, and appreciation of art. The cards may encourage

more people to visit the museum itself to share in its educational programs. The fact that the cards are promoted and sold in a commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact that the activity is related to the museum's exempt purpose. Therefore, these sales activities are not an unrelated trade or business.

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

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

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

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

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

On the other hand, the sale of **scientific books and souvenir items** of the city where the museum is located has no causal relationship to art or to artistic endeavor and, therefore, does not contribute importantly to the accomplishment of the museum's exempt educational purposes. The fact that selling some of these items could, under different circumstances, be held related to the exempt educational purpose of some other exempt educational organization does not change this conclusion. Additionally, the sale of these items does not lose its identity as a trade or business merely because the museum also sells articles which do contribute importantly to the accomplishment of its exempt function. Therefore, these sales are an unrelated trade or business.

Business league's parking and bus services. A business league, whose purpose is to retain and stimulate trade in a downtown area that has inadequate parking facilities, operates a fringe parking lot and shuttle bus service. It also operates, as an insubstantial part of its activities, a park and shop plan.

The fringe parking lot and shuttle bus service operate in a manner that does not favor any individual or group of downtown merchants. The merchants cannot offer free or discount parking or bus fares to their customers.

The park and shop plan allows customers of particular merchants to park free at certain parking lots in the area. Merchants participating in this plan buy parking stamps, which they distribute to their customers to use to pay for parking.

Operating the fringe parking lot and shuttle bus service provides easy and convenient access to the downtown area and, therefore, stimulates and improves business conditions in the downtown area generally. That activity contributes importantly to the organization's accomplishing its exempt purpose and is not an unrelated trade or business.

The park and shop plan encourages customers to use a limited number of participating member merchants in order to obtain free parking. This provides a particular service to individual members of the organization and does not further its exempt purpose. Therefore, operating the park and shop plan is an unrelated trade or business.

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

Health club program. An exempt charitable organization's purpose is to provide for the welfare of young people. The organization conducts charitable activities and maintains facilities that will contribute to the physical, social, mental, and spiritual health of young people at minimum or no cost to them. Nominal annual dues are charged for membership in the organization and use of the facilities.

In addition, the organization organized a health club program that its members could join for an annual fee in addition to the annual dues. The annual fee is comparable to fees charged by similar local commercial health clubs and is sufficiently high to restrict participation in the program to a limited number of members of the community.

The health club program is in addition to the general physical fitness program of the organization. Operating this program does not contribute importantly to the organization's accomplishing its exempt purpose and, therefore, is an unrelated trade or business.

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

The operation of the miniature golf course in a commercial manner does not contribute

importantly to the accomplishment of the organization's exempt purpose and, therefore, is an unrelated trade or business.

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

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

Selling endorsements. An exempt scientific organization enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of laboratory equipment to manufacturers. Endorsing laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted to the organization. Accordingly, the sale of endorsements is an unrelated trade or business.

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

Excluded Trade or Business Activities

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

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

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

Qualified sponsorship activities. Soliciting and receiving qualified sponsorship payments is not an unrelated trade or business, and the payments are not 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" does not 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 is not 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 are not 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 unrelated business taxable income.

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 does not apply to the part of the payment that is more than the fair market value of the product advertising.

Advertising. A payment is not 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 is not, 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 is not 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 does not, by itself, affect whether a payment qualifies.

Exception for periodicals. A payment is not 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 does not 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 products 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.

Exception for conventions and trade shows. A payment is not 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 later under *Convention or trade show activity*.

Selling donated merchandise. A trade or business that consists of selling merchandise, substantially all of which the organization received as gifts or contributions, is not 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, is not an unrelated trade or business.

Employee association sales. The sale of certain items by a local association of employees described in section 501(c)(4), organized before May 17, 1969, is not an unrelated trade or business if the items are sold for the convenience of the association's

members at their usual place of employment. This exclusion applies only to the sale of work-related clothes and equipment and items normally sold through vending machines, food dispensing facilities, or by snack bars.

Bingo games. Certain bingo games are not included in the term "unrelated trade or business." To qualify for this exclusion, the bingo game must meet the following requirements.

- 1) It meets the legal definition of bingo.
- 2) It is legal where it is played.
- 3) It is played in a jurisdiction where bingo games are not regularly carried on by for-profit organizations.

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

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

Legal where played. This exclusion applies only if bingo is legal under the laws of the jurisdiction where it is conducted. The fact that a jurisdiction's law that prohibits bingo is rarely enforced or is widely disregarded does not make the conduct of bingo legal for this purpose.

No for-profit games where played. This exclusion applies only if for-profit organizations cannot regularly carry on bingo games in any part of the same jurisdiction. Jurisdiction is normally the entire state; however, in certain situations, local jurisdiction will control.

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

Gambling activities other than bingo. Any game of chance conducted by an exempt organization in North Dakota is not an unrelated trade or business if conducting the game does not violate any state or local law.

Pole rentals. The term unrelated trade or business does not 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).

Distribution of low cost articles. The term unrelated trade or business does not include activities relating to the distribution of low cost articles incidental to soliciting charitable contributions. This applies to organizations described in section 501 that are eligible to receive charitable contributions.

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

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

An article is considered low cost if the cost of an item (or the aggregate costs if more than one item) distributed to a single recipient in a tax year is not more than \$5, indexed annually for inflation. The maximum cost of a low cost article is \$7.40, for 2000. The cost of an article is the cost to the organization that distributes the item or on whose behalf it is distributed.

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

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

Public entertainment activity. An unrelated trade or business does not 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.

Convention or trade show activity. An unrelated trade or business does not include *qualified* convention or trade show activities conducted at a convention, annual meeting, or trade show.

A *qualified* convention or trade show activity is any activity of a kind traditionally carried on by a *qualifying organization* in conjunction with an international, national, state, regional, or local convention, annual meeting, or show if:

- 1) One of the purposes of the organization in sponsoring the activity is promoting and stimulating interest in, and demand for, the products and services of that industry or educating the persons in attendance regarding new products and services or new rules and regulations affecting the industry, and
- 2) The show is designed to achieve its purpose through the character of the exhibits and the extent of the industry products that are displayed.

For these purposes, a *qualifying organization* is one described in section 501(c)(3), 501(c)(4), 501(c)(5), or 501(c)(6). The organization must regularly conduct, as one of its substantial exempt purposes, a qualified convention or trade show activity.

The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified convention or trade show is not an unrelated trade or business even if the exhibitors who rent the space are permitted to sell or solicit orders. For this purpose, a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, members of the qualifying organization in the conduct of these members' own trades or businesses.

4.

Unrelated Business Taxable Income

The term "unrelated business taxable income" generally means the gross income derived from any unrelated trade or business regularly carried on by the exempt organization, less the deductions directly connected

with carrying on the trade or business. If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to all the activities.

In computing unrelated business taxable income, 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 is not 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 unrelated business taxable income.

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 unrelated business taxable income.

Exception for insurance activity income of a controlled foreign corporation. This exclusion does not apply to income from certain insurance activities of an exempt organization's controlled foreign corporation. The income is not excludable dividend income, but instead is unrelated business taxable income 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 does not apply to unrelated debt-financed income (discussed under *Income From Debt-Financed Property*, later) or to interest or annuities received from a controlled corporation (discussed under *Income From Controlled Corporations*, later).

Income from lending securities. Payments received with respect to a security loan are excluded in computing unrelated business taxable income 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) Does not 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 unrelated business taxable income.

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 do not include payments for personal services. Therefore, payments for personal appearances and interviews are not excluded as royalties and must be included in figuring unrelated business taxable income.

Unrelated business taxable income does not 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 does not 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 are not 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 unrelated business taxable income. 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 does not 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 Corporations*, later).

Rents. Rents from real property, including elevators and escalators, are excluded in computing unrelated business taxable income. Rents from personal property are not 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 are not 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 does not 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 does not constitute rent from real property. Therefore, the exclusion does not 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 does not apply to unrelated debt-financed income (discussed under *Income From Debt-*

Financed Property, later) or to rents received from a controlled corporation (discussed under *Income From Controlled Corporations*, later).

Income from research. A tax-exempt organization may exclude income from research grants or contracts from unrelated business taxable income. 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 unrelated business taxable income.

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

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 unrelated business taxable income.

The term **research**, for this purpose, does not include activities of a type normally carried on 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** does not include research carried on for the primary purpose of commercial or industrial application.

Gains and losses from disposition of property. Also excluded from unrelated business taxable income 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 includable 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 unrelated business taxable income. The exclusion applies only if the option is written in connection with the exempt organization's investment activities. Therefore, this exclusion is not 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 does not apply to unrelated debt-financed income, discussed later under *Income From Debt-Financed Property*.

Income from services provided under federal license. There is a further exclusion from unrelated business taxable income of income from a trade or business carried on 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 since before May 27, 1959.
- 2) The trade or business must consist of providing services under a license issued by a federal regulatory agency.
- 3) More than 90% of the net income from the business for the tax year must be devoted to religious, charitable, or educational purposes that constitute the basis for the religious order's exemption.
- 4) The rates or other charges for these services must be fully competitive with the rates or other charges of similar taxable businesses. Rates or other charges for these services will be considered as fully competitive if they are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

Exception. This exclusion does not apply to unrelated debt-financed income (discussed later under *Income From Debt-Financed Property*).

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 are not treated as gross income from an unrelated trade or business, regardless of their purpose, if they are not more than the annual limit. The limit on dues paid by an associate member is \$112 for 2000.

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 unrelated business taxable income, the expenses, depreciation, and similar items generally must be allowable income tax deductions that are **directly connected** with carrying on an unrelated trade or business. They **cannot** 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 business, deductions must have a proximate and primary relationship to carrying on that 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 carry on 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 carry on 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 unrelated business taxable income, if the expense is otherwise an allowable income tax deduction.

Example 1. A school recognized as a tax-exempt organization contracts with an individual to conduct a summer tennis camp. The school provides the tennis courts, housing, and dining facilities. The contracted individual hires the instructors, recruits campers, and provides supervision. The income the school receives from this activity is from a dual use of the facilities and personnel. The school, in computing its unrelated business taxable income, may deduct an allocable part of the expenses attributable to the facilities and personnel.

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 unrelated business taxable

income, 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 are **not deductible** in computing unrelated business taxable income 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 do not have a proximate and primary relationship to the unrelated trade or business, and therefore, they do not 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 statements are true.

- 1) The unrelated business exploits the exempt activity.
- 2) The unrelated business is a type normally carried on 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 unrelated business taxable income (UBTI). The UBTI of an advertising activity is the amount shown in the following chart.

IF gross advertising income is...	THEN UBTI is...
More than direct advertising costs	The excess advertising income, reduced (but not below zero) by the excess, if any, of readership costs over circulation income.
Equal to or less than direct advertising costs	Zero. <ul style="list-style-type: none"> • Circulation income and readership costs are not taken into account. • Any excess advertising costs reduce (but not below zero) UBTI from any other unrelated business activity.

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

Periodical Income

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

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

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

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

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

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

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

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 is not 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 a 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 includable 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 that are 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, should be used consistently. Allocations based on dollar receipts from various exempt activities generally are not reasonable since receipts usually do not 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 unrelated business taxable income from selling advertising. It treats the gross income from all the periodicals, and the deductions directly connected with them, 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 Internal Revenue Service.

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 does not mean that the organization did not 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 is not 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 unrelated business taxable income. It may not consolidate the income and deductions from the newsletter with the income and deductions of its other periodicals, since the newsletter is not published for the production of income.

Modifications

Net operating loss deduction. The net operating loss deduction (as provided in section 172) is allowed in computing unrelated business taxable income. However, the net operating loss for any tax year, the carrybacks and carryovers of net operating losses, and the net operating loss deduction are determined without taking into account any amount of income or deduction that has been specifically excluded in computing unrelated business taxable income. For example, a loss from an unrelated trade or business is not diminished because dividend income was received.

If this were not done, organizations would, in effect, be taxed on their exempt income, since unrelated business losses then would be offset by dividends, interest, and other excluded income. This would reduce the loss that could be applied against unrelated business income of prior or future tax years. Therefore, to preserve the immunity of exempt income, all net operating loss computations are limited to those items of income and

deductions that affect the unrelated business taxable income.

In line with this concept, a net operating loss carryback or carryover is allowed only from a tax year for which the organization is subject to tax on unrelated business income.

For example, if an organization just became subject to the tax last year, its net operating loss for that year is not a carryback to a prior year when it had no unrelated business taxable income, nor is its net operating loss carryover to succeeding years reduced by the related income of those prior years.

However, in determining the span of years for which a net operating loss may be carried back or forward, the tax years for which the organization is not subject to the tax on unrelated business income are counted. For example, if an organization was subject to the tax for 1996 and had a net operating loss for that year, the last tax year to which any part of that loss may be carried over is 2011, regardless of whether the organization was subject to the unrelated business income tax in any of the intervening years.

Charitable contributions deduction. An exempt organization is allowed to deduct its charitable contributions in computing its unrelated business taxable income whether or not the contributions are directly connected with the 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 unrelated business taxable income computed without regard to the deduction for contributions.

An exempt trust that is subject to the unrelated business income tax at trust rates generally is 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 unrelated business taxable income 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 is not allowed, however, to the extent that it increases a net operating loss carryover.

Specific deduction. In computing unrelated business taxable income, a specific deduction of \$1,000 is allowed. However, the specific deduction is not allowed in computing a net operating loss or the net operating loss 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 carried on by the local unit.

This exception applies only to parishes, districts, or other local units that are not 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 are not separate legal entities. The local units cannot file separate returns. However, each local unit that is separately incorporated must file its own return and cannot 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 a partnership, 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.

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 unrelated business taxable income 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 unrelated business taxable income are figured the same way as any income and deductions from an unrelated trade or business conducted directly by the organization.

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 unrelated business taxable income, 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 unrelated business taxable income must be based on the income and deductions of the partnership for the partnership's tax year that ends within or with 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, or losses in figuring unrelated business taxable income, 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 unrelated business taxable income. The organization must also take into account its gain or loss on the sale or other disposition of the S corporation stock in figuring unrelated business taxable income.

Special Rules for Foreign Organizations

The unrelated business taxable income 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, plus
- 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).

These organizations must figure unrelated business taxable income under special rules.

Unlike other exempt organizations, they cannot 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 unrelated business taxable income of these organizations includes all gross income, less deductions directly connected with the production of that income, except that gross income for this purpose does not include **exempt function income**. The dividends received deduction for corporations is not allowed in computing unrelated business taxable income because it is not an expense incurred in the production of income.

Losses from nonexempt activities. Losses from nonexempt activities of these organizations cannot be used to offset investment income unless the activities were undertaken with the intent to make a profit.

Example. A private golf and country club that is a qualified tax-exempt social club has nonexempt function income from interest and from the sale of food and beverages to nonmembers. The club sells food and beverages as a service to members and their guests rather than for the purpose of making a profit. Therefore, any loss resulting from sales to nonmembers cannot be used to offset the club's interest income.

Modifications. The unrelated business taxable income is modified by any net operating loss 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 that is 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).

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

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) does not 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 unrelated business taxable income 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 unrelated business taxable income are allowed.



For a payment made under a contract in effect on June 8, 1997, and received during the first 2 tax years beginning after August 4, 1997, the definition of a controlled organization and the computation of the amount included in the controlling organization's unrelated business taxable income are different. See section 1.512(b)-1(l) of the regulations for details.

Net unrelated income. This is:

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

Net unrelated loss. This is:

- For an exempt organization, its net operating loss, or
- For a nonexempt organization, the part of its net operating loss that would be its net operating loss 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.

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

Income From Debt-Financed Property

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

Debt-Financed Property

In general, the term "debt-financed property" means any property held to produce income (including gain from its disposition) for which there is an **acquisition indebtedness** at any time during the tax year (or during the 12-month period before the date of the property's disposal, if it was disposed of during the tax year). It includes rental real estate, tangible personal property, and corporate stock.

Acquisition Indebtedness

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example. An exempt organization paid \$50,000 for real property valued at \$150,000 and subject to a \$100,000 mortgage. The \$100,000 of outstanding principal debt is acquisition indebtedness, as though the organization had borrowed \$100,000 to buy the property.

Liens similar to a mortgage. In determining acquisition indebtedness, a lien similar to a mortgage is treated as a mortgage. A lien is similar to a mortgage if title to property is encumbered by the lien for a creditor's benefit. However, when state law provides that a **lien for taxes** or assessments attaches to property before the taxes or assessments become due and payable, the lien is not treated as a mortgage until after the taxes or assessments have become due and payable and the organization has had an opportunity to pay the lien in accordance with state law. Liens similar to mortgages include (but are not limited to):

- 1) Deeds of trust,
- 2) Conditional sales contracts,
- 3) Chattel mortgages,
- 4) Security interests under the Uniform Commercial Code,
- 5) Pledges,
- 6) Agreements to hold title in escrow, and
- 7) Liens for taxes or assessments (other than those discussed earlier in this paragraph).

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

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

This exception does not apply if an organization assumes and agrees to pay all or part of the debt secured by the mortgage or makes any payment for the equity in the property owned by the donor or decedent (other than a payment under an annuity obligation excluded from the definition of acquisition indebtedness, discussed later under *Debt That Is Not Acquisition Indebtedness*).

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

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

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

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

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

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

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

Debt That Is Not Acquisition Indebtedness

Certain debt and obligations are not acquisition indebtedness. These include the following.

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

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

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

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

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

Securities loans. Acquisition indebtedness does not include an obligation of the exempt organization to return collateral security provided by the borrower of the exempt organ-

ization's securities under a securities loan agreement (discussed under *Exclusions* earlier in this chapter). This transaction is not treated as the borrowing by the exempt organization of the collateral furnished by the borrower (usually a broker) of the securities.

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

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

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

- 1) A qualified retirement plan under section 401(a),
- 2) An educational organization described in section 170(b)(1)(A)(ii) and certain of its affiliated support organizations, or
- 3) A title-holding company described in section 501(c)(25).

This exception from acquisition indebtedness **does not apply** in the following six situations.

- 1) The acquisition price is not a fixed amount determined as of the date of the acquisition or the completion of the improvement. However, the terms of a sales contract may provide for price adjustments due to customary closing adjustments such as prorating property taxes. The contract also may provide for a price adjustment if it is for a fixed amount dependent upon subsequent resolution of limited, external contingencies such as zoning approvals, title clearances, and the removal of easements. These conditions in the contract will not cause the price to be treated as an undetermined amount. (But see *Note 1* at the end of this list.)
- 2) Any debt or other amount payable for the debt, or the time for making any payment, depends, in whole or in part, upon any revenue, income, or profits derived from the real property. (But see *Note 1* at the end of this list.)
- 3) The real property is leased back to the seller of the property or to a person related to the seller as described in section 267(b) or section 707(b). (But see *Note 2* at the end of this list.)
- 4) The real property is acquired by a qualified retirement plan from, or after its acquisition is leased by a qualified retirement plan to, a related person. (But see *Note 2* at the end of this list.) For this purpose, a related person is:

- a) An employer who has employees covered by the plan,
 - b) An owner with at least a 50% interest in an employer described in (a),
 - c) A member of the family of any individual described in (a) or (b),
 - d) A corporation, partnership, trust, or estate in which a person described in (a), (b), or (c) has at least a 50% interest, or
 - e) An officer, director, 10% or more shareholder, or highly compensated employee of a person described in (a), (b), or (d).
- 5) The seller, a person related to the seller (under section 267(b) or section 707(b)), or a person related to a qualified retirement plan (as described in (4)) provides financing for the transaction on other than commercially reasonable terms.
 - 6) The real property is held by a partnership in which an exempt organization is a partner (along with taxable entities), and the principal purpose of any allocation to an exempt organization is to avoid tax. This generally applies to property placed in service after 1986. For more information, see section 514(c)(9)(B)(vi) and section 514(c)(9)(E).

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

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

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

Exceptions to Debt-Financed Property

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

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

- 1) A comparison of the time the property is used for exempt purposes with the total time the property is used,
- 2) A comparison of the part of the property that is used for exempt purposes with the part used for all purposes, or
- 3) Both of these comparisons.

If less than 85% of the use of any property is devoted to an organization's exempt pur-

poses, only that part of the property that is used to further the organization's exempt purposes is not treated as debt-financed property.

Property used in an unrelated trade or business. To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, the property is not treated as debt-financed property. However, any gain on the disposition of the property that is not included in income from an unrelated trade or business is includable as gross income derived from, or on account of, debt-financed property.

The rules for debt-financed property do not apply to rents from personal property, certain passive income from controlled organizations, and other amounts that are required by other rules to be included in computing unrelated business taxable income.

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

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

- 1) It has a volunteer workforce,
- 2) It is carried on for the convenience of its members, or
- 3) It consists of selling donated merchandise.

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

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

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

- 1) One organization is an exempt holding company and the other receives profits derived by the exempt holding company,
- 2) One organization controls the other as discussed under *Income From Controlled Organizations* earlier in this chapter,
- 3) More than 50% of the members of one organization are members of the other, or
- 4) Each organization is a local organization directly affiliated with a common state, national, or international organization that also is exempt.

Medical clinics. Real property is not debt-financed property if it is leased to a medical clinic and the lease is entered into primarily

for purposes related to the lessor's exercise or performance of its exempt purpose.

Example. An exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons. They, under the lease, agree to provide all of the hospital's outpatient medical and surgical services and to train all of the hospital's residents and interns. In this case the rents received are not unrelated debt-financed income.

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

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

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

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

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

Exceptions. For all organizations other than churches and conventions or associations of churches, discussed later under *Churches*, the neighborhood land rule does not apply to property after the 10 years following its acquisition. Further, the rule applies after the first 5 years only if the organization satisfies the IRS that use of the land for exempt purposes is reasonably certain before the 10-year period expires. The organization need not show binding contracts to satisfy this requirement; but it must have a definite plan detailing a specific improvement and a completion date, and it must show some affirmative action toward the fulfillment of the plan. This information should be forwarded to the IRS for a ruling at least 90 days before the end of the 5th year after acquisition of the land. Address it to:

Internal Revenue Service
 Commissioner, TE/GE
 Attention: T:EO:RA
 P.O. Box 120, Ben Franklin Station
 Washington, DC 20044

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

Actual use. If the neighborhood land rule does not apply because the acquired land is not in the neighborhood of other land used for an organization's exempt purposes, or because the organization fails to establish after the first 5 years of the 10-year period that the property will be used for exempt purposes, but the land is used eventually by the organization for its exempt purposes within the 10-year period, the property is not treated as debt-financed property for any period before the conversion.

Limits. The neighborhood land rule or actual use rule applies to any structure on the land when acquired, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in this manner. Thus, during the first 5 years after acquisition (and for later years if there is a favorable ruling), improved property is not debt financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. If an actual demolition of these structures occurs, the use made of the land need not be the one originally intended as long as its use furthers the organization's exempt purpose.

In addition to this limit, the neighborhood land rule and the actual use rule do not apply to structures erected on land after its acquisition. They do not apply to property subject to a **business lease** (as defined in section 514 immediately before the enactment of the Tax Reform Act of 1976) whether an organization acquired the property subject to the lease, or whether it executed the lease after acquisition. A business lease is any lease, with certain exceptions, of real property for a term of more than 5 years by an exempt organization if at the close of the lessor's tax year there is a business lease (acquisition) indebtedness on that property.

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

Example. In January 1992, Y, a calendar year exempt organization, acquired real property contiguous to other property that Y uses in furtherance of its exempt purpose. Assume that without the neighborhood land rule, the property would be debt-financed property. Y did not satisfy the IRS by January 1997 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 1997 until the property is converted to an exempt use, the income from the property is subject to the tax on unrelated business income. During July 2001, Y will demolish the

existing structure on the land and begin using the land in furtherance of its exempt purpose. At that time, Y can file claims for refund for the open years 1998 through 2000.

Further, Y also can file a claim for refund for 1997, even though a claim for that tax year may be barred by the statute of limitations, provided the claim is filed before the close of 2002.

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

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

Thus, if a church or association or convention of churches acquires real property for the primary purpose of using the land in the exercise or performance of its exempt purpose, within 15 years after the time of acquisition, the property is not treated as debt-financed property as long as the organization does not abandon its intent to use the land in this manner within the 15-year period.

This exception for a church or association or convention of churches does not apply to any property after the 15-year period expires. Further, this rule will apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the IRS that use of the acquired land in furtherance of the organization's exempt purpose is reasonably certain before the 15-year period expires.

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

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

Computation of Debt-Financed Income

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

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

Example. X, an exempt trade association, owns an office building that is debt-financed property. The building produced \$10,000 of gross rental income last year. The

average adjusted basis of the building during that year was \$100,000, and the average acquisition indebtedness with respect to the building was \$50,000. Accordingly, the debt/basis percentage was 50% (the ratio of \$50,000 to \$100,000). Therefore, the unrelated debt-financed income with respect to the building was \$5,000 (50% of \$10,000).

Gain or loss from sale or other disposition of property. If an organization sells or otherwise disposes of debt-financed property, it must include, in computing unrelated business taxable income, a percentage (not over 100%) of any gain or loss. The percentage is that of the highest acquisition indebtedness with respect to the property during the 12-month period preceding the date of disposition, in relation to the property's average adjusted basis.

The tax on this percentage of gain or loss is determined according to the usual rules for capital gains and losses. These amounts may be subject to the alternative minimum tax. (See *Alternative minimum tax* at the beginning of chapter 2.)

Debt-financed property exchanged for subsidiary's stock. A transfer of debt-financed property by a tax-exempt organization to its wholly owned taxable subsidiary, in exchange for additional stock in the subsidiary, is not considered a gain subject to the tax on unrelated business income.

Example. A tax-exempt hospital wants to build a new hospital complex to replace its present old and obsolete facility. The most desirable location for the new hospital complex is a site occupied by an apartment complex. Several years ago the hospital bought the land and apartment complex, taking title subject to a first mortgage already on the premises.

For valid business reasons, the hospital proposed to exchange the land and apartment complex, subject to the mortgage on the property, for additional stock in its wholly owned subsidiary. The exchange satisfied all the requirements of section 351(a).

The transfer of appreciated debt-financed property from the tax-exempt hospital to its wholly owned subsidiary in exchange for stock did not result in a gain subject to the tax on unrelated business income.

Average acquisition indebtedness. This is the average amount of outstanding principal debt during the part of the tax year that the organization holds the property.

Average acquisition indebtedness is computed by determining how much principal debt is outstanding on the first day in each calendar month during the tax year that the organization holds the property, adding these amounts, and dividing the sum by the number of months during the year that the organization held the property. Part of a month is treated as a full month in computing average acquisition indebtedness.

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

completion of the improvement, less any down payment or other initial payment applied to the principal debt.

$$\frac{\text{Debt/basis percentage}}{\$250,000} = 50\%$$

$$\frac{\$500,000}{\$500,000}$$

Average adjusted basis. The average adjusted basis of debt-financed property is the average of the adjusted basis of the property as of the first day and as of the last day that the organization holds the property during the tax year.

Determining the average adjusted basis of the debt-financed property is not affected if the organization was exempt from tax for prior tax years. The basis of the property must be adjusted properly for the entire period after the property was acquired. As an example, adjustment must be made for depreciation during all prior tax years whether or not the organization was tax-exempt. If only part of the depreciation allowance may be taken into account in computing the percentage of deductions allowable for each debt-financed property, that does not affect the amount of the depreciation adjustment to use in determining average adjusted basis.

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

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

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

<u>Month</u>	<u>Debt on first day of each month property is held</u>
July	\$ 300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	<u>\$1,500,000</u>
Average acquisition indebtedness:	
\$1,500,000 ÷ 6 months	<u>\$ 250,000</u>
<u>Basis</u>	
As of July 7	\$ 510,000
As of December 31	<u>490,000</u>
Total	<u>\$1,000,000</u>
Average adjusted basis:	
\$1,000,000 ÷ 2	<u>\$ 500,000</u>

Deductions for Debt-Financed Property

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

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

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

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

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

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

If any part of the allowable capital loss is not taken into account in the current tax year, it may be carried back or carried over to another tax year without application of the debt/basis percentage for that year.

Example. X, an exempt educational organization, owned debt-financed securities that were capital assets. Last year, X sold the securities at a loss of \$20,000. The debt/basis percentage for computing the loss from the sale of the securities is 40%. Thus, X sustained a capital loss of \$8,000 (40% of \$20,000) on the sale of the securities. Last year and the preceding 3 tax years, X had no other capital transactions. Under these circumstances, the \$8,000 of capital loss may be carried over to succeeding years without further application of the debt/basis percentage.

Net operating loss. If, after applying the debt/basis percentage to the income from debt-financed property and the deductions directly connected with this income, the deductions exceed the income, an organization has a net operating loss for the tax year. This amount may be carried back or carried over

to other tax years in the same manner as any other net operating loss of an organization with unrelated business taxable income. (For a discussion of the net operating loss deduction, see *Modifications* under *Deductions* earlier in this chapter.) However, the debt/basis percentage is not applied in those other tax years to determine the deductions that may be taken in those years.

Example. Last year, Y, an exempt organization, received \$20,000 of rent from a debt-financed building that it owns. Y had no other unrelated business taxable income for the year. The deductions directly connected with this building were property taxes of \$5,000, interest of \$5,000 on the acquisition indebtedness, and salary of \$15,000 to the building manager. The debt/basis percentage with respect to the building was 50%. Under these circumstances, Y must take into account, in computing its unrelated business taxable income, \$10,000 (50% of \$20,000) of income and \$12,500 (50% of \$25,000) of the deductions directly connected with that income.

Thus, Y sustained a net operating loss of \$2,500 (\$10,000 of income less \$12,500 of deductions), which may be carried back or carried over to other tax years without further application of the debt/basis percentage.

Allocation Rules

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

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

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

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

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

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


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

5.

How To Get More Information

You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

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- *Tax Info For You* to view Internal Revenue Bulletins published in the last few years.
- *Tax Regs in English* to search regulations and the Internal Revenue Code (under *United States Code (USC)*).
- *Digital Dispatch* and *IRS Local News Net* (both located under *Tax Info For Business*) to receive our electronic newsletters on hot tax issues and news.
- *Small Business Corner* (located under *Tax Info For Business*) to get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](ftp://ftp.irs.gov).



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- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

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- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



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