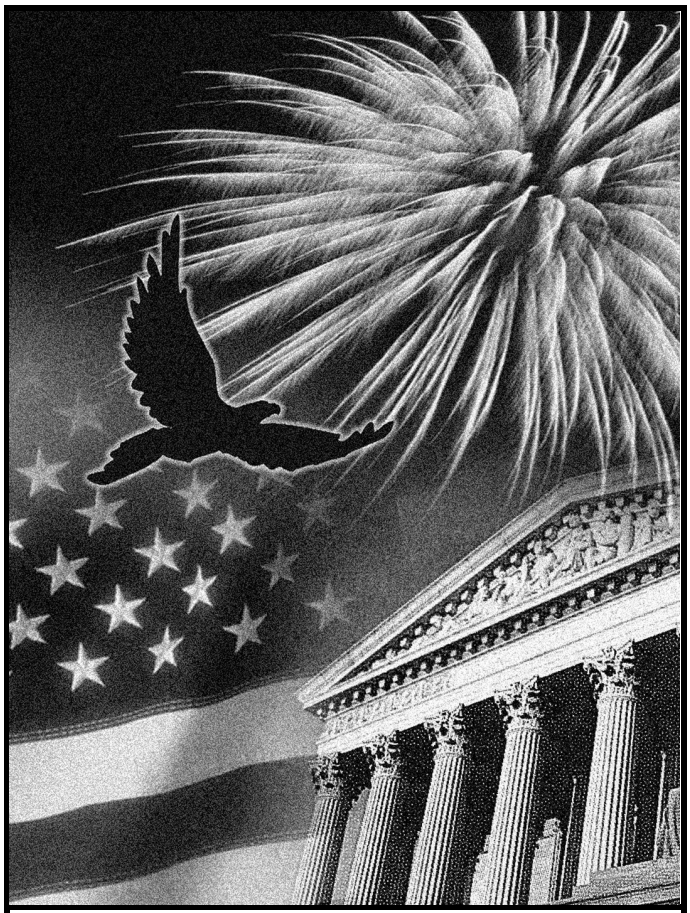
Department of the Treasury

Internal Revenue Service

Publication 598
(Rev. March 2012)

Cat. No. 46598X

Tax on Unrelated Business Income of Exempt Organizations



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What's New

- Federal tax deposits must be made by electronic funds transfer. Beginning January 1, 2011, you must use electronic funds transfer to make all federal tax deposits. Forms 8109 and 8109-B, Federal Tax Deposit Coupon, cannot be used after 2010. See *Federal Tax Deposits Must be Made by Electronic Funds Transfer* on page 3.
- For large corporations, special rules apply for estimated tax payments that are required to be made for the period that includes July, August, or September of 2012, and the period that immediately follows these months. See the instructions for line 12 on the 2012 Form 990-W (Worksheet), Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations.
- The maximum cost of a low-cost article, for organizations eligible to receive charitable contributions, was increased to $9.70 for 2011. See *Distribution of low-cost articles* on page 8.
- The annual limit on associate member dues received by an agricultural or horticultural organization not treated as gross income was increased to $148 for 2011. See Exception under *Dues of Agricultural Organizations and Business Leagues* on page 10.
- The IRS has created a page on IRS.gov that includes information about Pub. 598 at www.irs.gov/pub598.

Introduction

An exempt organization is not taxed on its income from an activity 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 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.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can write to us at:

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

You can email us at *taxforms@irs.gov*. Please put "publications Comment" on the subject line. You can also send us comments from *www.irs.gov/formspubs/*, select "Comment on Tax Forms and Publications" under "Information about."

Although we cannot respond individually to each comment received, we do appreciate your feedback and will consider your comments as we revise our tax products.

Reminders

An organization may elect to treat any GO Zone public utility loss as a specified liability loss. Certain other losses attributable to GO Zone losses, including those from Kiowa County, Kansas and other Midwestern disaster areas, are eligible for special carryback treatment. See *Net operating loss deduction* on page 12.

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, Coverdell 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).
- Coverdell savings accounts described in section 530.

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 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 tax exempt subsidiary organizations. 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 conduct 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 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.

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 Coverdell 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 Form 990-T filer may request an automatic 3-month (6 months for corporation) extension of time to file a return by submitting Form 8868, Application for Extension of Time To File an Exempt Organization Return. The Form 990-T filer may also use Form 8868 to apply for an additional (not automatic) 3-month extension to file the return if the original 3-month extension was not enough time.

Public Inspection Requirements of Section 501(c)(3) Organizations. Under section 6104(d), a section 501(c)(3) organization that has gross income from an unrelated trade or business of $1,000 or more must make its annual exempt organization business income tax return (including amended returns) available for public inspection.

TIP *A section 501(c)(3) organization filing the Form 990-T only to request a credit for certain federal excise taxes paid does not have to make the Form 990-T 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), 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).

Federal Tax Deposits Must be Made by Electronic Funds Transfer

You must use electronic funds transfer to make all federal deposits (such as deposits of estimated tax, employment tax, and excise tax). Forms 8109 and 8109-B, Federal Tax Deposit Coupon, are no longer in use. Generally, electronic fund transfers are made using the Electronic Federal Tax Payment System (EFTPS). If you do not want to use EFTPS, you can arrange for your tax professional, financial institution, payroll service, or other trusted third party to make deposits on your behalf. Also, you may arrange for your financial institution to initiate a same-day wire payment on your behalf. EFTPS is a free service provided by the Department of Treasury. Services provided by your tax professional, financial institution, payroll service, or other third party may have a fee. To get more information about EFTPS or to enroll in EFTPS, visit www.eftps.gov or call 1-800-555-4477. Additional information about EFTPS is available in Publication 966, The Secure Way to Pay Your Federal Taxes.

Deposits on business days only. If a deposit is required to be made on a day that is not a business day, the deposit is considered timely if it is made by the close of the next business day. A business day is any day other than a Saturday, Sunday, or legal holiday. For example, if a deposit is required to be made on a Friday and Friday is a legal holiday, the deposit will be considered timely if it is made by the following Monday (if that Monday is a business day). The term "legal holiday" means any legal holiday in the District of Columbia.

3. Unrelated Trade or Business

Unrelated business income. Unrelated business income is the income from a trade or business regularly conducted by an exempt organization and 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 conducted 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 conducted 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 conducted. Business activities of an exempt organization ordinarily are considered regularly conducted 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 conducted. 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 rent from real property and unrelated business taxable income.

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 conducted 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, 5 or 6 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 conducted 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 conducted 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 conduct 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 $9.70 for 2011. 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 conducted 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.

Certain Internet activities conducted by a trade association described in section 501(c)(6) will be considered qualified convention and trade show activity if conducted on a special supplementary section of the association's website in conjunction with a trade show conducted by the association. The trade show itself must be a qualified convention and trade show activity. The supplementary section of the website must be ancillary to, and serve to augment and enhance, the trade show, as when it makes available the same information available at the trade show and is available only during a time period that coincides with the time period that the trade show is in operation. Conversely, Internet activities that are not conducted in conjunction with a

qualified convention and trade show activity and that do not augment and enhance the trade show cannot themselves be qualified convention and trade show activity.

4.

Unrelated Business Taxable Income

The term "unrelated business taxable income" generally means the gross income derived from any unrelated trade or business regularly conducted by the exempt organization, less the deductions directly connected with carrying on the trade or business. 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), to interest or annuities received from a controlled corporation (discussed under *Income From Controlled Organizations*, later).

Income from lending securities. Payments received with respect to a security loan are excluded in computing 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 Organizations,* 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 interest, annuities, royalties and rents received from a controlled corporation (discussed under *Income From Controlled Organizations,* later), investment income (dividends, interest, rents, etc.) received by organizations described in sections 501(c)(7), 501(c)(9), 501(c)(17), and 501(c)(20). See *Special Rules for Social Clubs, VEBAs, SUBs, and GLSOs,* discussed later for more information.

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 conducted as an incident to commercial or industrial operations, such as testing or inspecting materials or products, or designing or constructing equipment, buildings, etc. In addition, the term fundamental research does not include research conducted 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*.

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

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

This exclusion applies only if the following requirements are met.

1. The trade or business must have been operated by the order or by the institution before May 27, 1959.
2. The trade or business must provide services under a license issued by a federal regulatory agency.
3. More than 90% of the net income from the business for the tax year must be devoted to religious, charitable, or educational purposes that constitute the basis for the religious order's exemption.
4. The rates or other charges for these services must be fully competitive with the rates or other charges of similar taxable businesses. Rates or other charges for these services will be considered as fully competitive if they are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

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

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

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 $148 for 2011.

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 conduct the unrelated business and depreciation of a building used entirely in the conduct of that business are deductible to the extent otherwise allowable.

Expenses attributable to dual use of facilities or personnel. When facilities or personnel are used both to conduct exempt functions and to conduct an unrelated trade or business, expenses, depreciation, and similar items attributable to the facilities or personnel must be allocated between the two uses on a reasonable basis. The part of an item allocated to the unrelated trade or business is proximately and primarily related to that business and is allowable as a deduction in computing 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 × 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 conducted for profit by taxable organizations.
3. The exempt activity is a type normally conducted by taxable organizations in carrying on that type of business.

The amount treated as directly connected is the smaller of:

1. The excess of these expenses, depreciation, and similar items over the income from, or attributable to, the exempt activity; or
2. The gross unrelated business income reduced by all other expenses, depreciation, and other items that are actually directly connected.

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

Exploitation of Exempt Activity—Advertising Sales

The sale of advertising in a periodical of an exempt organization that contains editorial material related to the accomplishment of the organization's exempt purpose is an unrelated business that exploits an exempt activity, the circulation and readership of the periodical. Therefore, in addition to direct advertising costs, exempt activity costs (expenses, depreciation, and similar expenses attributable to the production and distribution of the editorial or readership content) can be treated as directly connected with the conduct of the advertising activity. (See *Expenses attributable to exploitation of exempt activities* under *Directly Connected*, earlier.)

Figuring 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. • 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: $\frac{\text{Total periodical costs}}{\text{Total periodical costs Plus Cost of other exempt activities}}$

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 (NOL) deduction (as provided in section 172) is allowed in computing unrelated business taxable income. However, the NOL for any tax year, the carrybacks and carryovers of NOLs, and the NOL 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 NOL computations are limited to those items of income and deductions that affect the unrelated business taxable income.

In line with this concept, an NOL 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 NOL for that year is not a carryback to a prior year when it had no unrelated business taxable income, nor is its NOL carryover to succeeding years reduced by the related income of those prior years.

However, in determining the span of years for which an NOL 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 2009 and had an NOL for that year, the last tax year to which any part of that loss may be carried over is 2029, regardless of whether the organization was subject to the unrelated business income tax in any of the intervening years.

For more details on the NOL deduction, including property eligible for an extended carryback period, see sections 172 and 1400N, Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts, and Publication 4492-B, Information for Affected Taxpayers in the Midwestern Disaster Areas.

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. See the Instructions for Form 990-T for more information.

An exempt trust that is subject to the unrelated business income tax at trust rates 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 an NOL carryover.

Suspension of deduction limits for farmers and ranchers. The limitations discussed above are temporarily suspended for certain qualified conservation contributions of property used in agriculture or livestock production. See the Instructions for Form 990-T for details.

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 an NOL or the NOL deduction.

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

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

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

This exception applies only to parishes, districts, or other local units that 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. The organization is required to notify the partnership of its tax-exempt status.

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. The partnership is required to provide the organization this information on Schedule K-1.

Example. An exempt educational organization is a partner in a partnership that operates a factory. The partnership also holds stock in a corporation. The exempt organization must include its share of the gross income from operating the factory in its 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, and
2. Unrelated business taxable income effectively connected with the conduct of a trade or business within the United States, whether or not this income is derived from sources within the United States.

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

Special Rules for Social Clubs, VEBAs, SUBs, and GLSOs

The following discussion applies to:

- ***Social clubs*** described in section 501(c)(7),
- ***Voluntary employees' beneficiary associations (VEBAs)*** described in section 501(c)(9),
- ***Supplemental unemployment compensation benefit trusts (SUBs)*** described in section 501(c)(17), and
- ***Group legal services organizations (GLSOs)*** described in section 501(c)(20).

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 by a corporation are 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 NOL or charitable contributions deduction and by the specific deduction (described earlier under *Deductions*).

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

Income that is set aside. This is income set aside to be used for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. In addition, for a VEBA, SUB, or GLSO, it is income set aside to provide for the payment of life, sick, accident, or other benefits.

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

Income derived from an unrelated trade or business may not be set aside and therefore 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.

Excess qualifying specified payments. Excess qualifying specified payments received or accrued from a controlled entity are included in a controlling exempt organization's unrelated business taxable income only on the amount that exceeds that which would have been paid or accrued if the payments had been determined under section 482. Qualifying specified payments means any payments of interest, annuities, royalties, or rents received or accrued from the controlled organization pursuant to a binding written contract in effect on August 17, 2006, or to a contract which is a renewal, under substantially similar terms of a binding written contract in effect on August 17, 2006, and the payments are received or accrued before January 1, 2012.

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

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

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

Control. An organization is controlled if:

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

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

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

Income from property financed with qualified 501(c)(3) bonds.

If any part of a 501(c)(3) organization's property financed with qualified 501(c)(3) bonds is used in a trade or business of any person other than a section 501(c)(3) organization or a governmental unit, and such use is not consistent with the requirements for qualified 501(c)(3) bonds under section 145, the 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. See sections 150(b)(3) and (c) for more information.

Disposition of property received from taxable subsidiary and used in unrelated business.

A taxable 80%-owned subsidiary corporation of one or more tax-exempt entities is generally subject to tax on a distribution in liquidation of its assets to its exempt parent (or parents). The assets are treated as if sold at fair market value.

Tax-exempt entities include organizations described in sections 501(a), 529, and 115, charitable remainder trusts, U.S. and foreign governments, Indian tribal governments, international organizations, and similar non-taxable organizations.

A taxable corporation that transfers substantially all of its assets to a tax-exempt entity in a transaction that otherwise qualifies for nonrecognition treatment must recognize gain on the transaction as if it sold the assets at fair market value. However, such a transfer is not taxable if it qualifies as a like-kind exchange under section 1031 or an involuntary conversion under section 1033. In such a case the built-in appreciation is preserved in the replacement property received in the transaction.

A corporation that changes status from taxable to tax-exempt is treated generally as if it transferred all of its assets to a tax-exempt entity immediately before the change in status (thus subjecting it to the tax on a deemed sale for fair market value). This rule does not apply where the taxable corporation becomes exempt within 3 years of formation, or had previously been exempt and within several years (generally a period of 3 years) regains exemption, unless the principal purpose of the transactions is to avoid the tax on the change in status.

In the transactions described above, the taxable event is deferred for property that the tax-exempt entity immediately uses in an unrelated business. If the parent later disposes of the property, then any gain (not in excess of the amount not recognized) is included in the parent's unrelated business taxable income. If there is partial use of the assets in unrelated business, then there is partial recognition of gain or loss. Property is treated as disposed if the tax-exempt entity no longer uses it in an unrelated business.

Losses on the transfer of assets to a tax-exempt entity are disallowed if part of a plan with a principal purpose of recognizing losses.

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 under *Debt That Is Not Acquisition Indebtedness*, later).

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 organization'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,
3. A title-holding company described in section 501(c)(25), or
4. A retirement income account described in section 403(b)(9) in acquiring or improving real property in tax years beginning on or after August 17, 2006.

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. However, 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. However, 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). However, 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. however, 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.

In addition, acquisition indebtedness does not include indebtedness incurred by a small business investment company licensed under the Small Business Investment Act of 1958 after October 22, 2004, if such indebtedness is evidenced by a debenture issued by such company and held or guaranteed by the Small Business Administration. However, this provision does not apply to any small business investment company during any period that any organization which is exempt from tax (other than a governmental unit) owns more than 25% of the capital or profits interest in such company, or organizations which are exempt from tax (including governmental agencies other than any agency or instrumentality of the United States) own, in the aggregate, 50% or more of the capital or profits interest in such company.

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 purposes, only that part of the property 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 not included in income from an unrelated trade or business is includible 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 conducted 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 1 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. Send information 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 1.514(f)-1 of the regulations) 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 1 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 2001, 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 2006 that the existing structure would be demolished and the land would be used in furtherance of its exempt purpose. From 2006 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 2010, 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 2007 through 2009.

Further, Y also can file a claim for refund for 2006, 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 2011.

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 of the property's average adjusted basis for the year (the debt/basis percentage). Thus, the formula for deriving unrelated debt-financed income is:

$$\frac{\text{average acquisition indebtedness}}{\text{average adjusted basis}} \times \text{gross income from debt-financed property}$$

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.

Gain or loss on disposition of certain brownfield property. Gain or loss from the qualifying sale, exchange, or other disposition of a qualifying brownfield property (as defined in section 512(b)(19)(C)), which was acquired by the organization after December 31, 2004, is excluded from unrelated business taxable income and is excepted from the debt-financed rules for such property. See sections 512(b)(19) and 514(b)(1)(E).

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.

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:

Month	Debt on first day of each month property is held
July	$ 300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	$1,500,000

Average acquisition indebtedness:
$1,500,000 ÷ 6 months = $ 250,000

	Basis
As of July 7	$ 510,000
As of December 31	490,000
Total	$1,000,000

Average adjusted basis:
$1,000,000 ÷ 2 = $ 500,000

Debt/basis percentage

$250,000 ÷ $500,000 = 50%

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,* earlier.

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 an NOL for the tax year. This amount may be carried back or carried over to other tax years in the same manner as any other NOL of an organization with unrelated business taxable income. (For a discussion of the NOL 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 an NOL 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.	$3,000

How to Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get 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.

Contacting your Taxpayer Advocate. The Taxpayer Advocate Service (TAS) is an independent organization within the IRS. We help taxpayers who are experiencing economic harm, such as not being able to provide necessities like housing, transportation, or food; taxpayers who are seeking help in resolving tax problems with the IRS; and those who believe that an IRS system or procedure is not working as it should. Here are seven things every taxpayer should know about TAS:

- The Taxpayer Advocate Service is your voice at the IRS.
- Our service is free, confidential, and tailored to meet your needs.
- You may be eligible for our help if you have tried to resolve your tax problem through normal IRS channels and have gotten nowhere, or you believe an IRS procedure just isn't working as it should.
- We help taxpayers whose problems are causing financial difficulty or significant cost, including the cost of professional representation. This includes businesses as well as individuals.
- Our employees know the IRS and how to navigate it. If you qualify for our help, we'll assign your case to an advocate who will listen to your problem, help you understand what needs to be done to resolve it, and stay with you every step of the way until your problem is resolved.
- We have at least one local taxpayer advocate in every state, the District of Columbia, and Puerto Rico. You can call your local advocate, whose number is in your phone book, in Pub. 1546, Taxpayer Advocate Service — Your Voice at the IRS, and on our website at www.irs.gov/advocate. You can also call our toll-free line at 1-877-777-4778 or TTY/TDD 1-800-829-4059.
- You can learn about your rights and responsibilities as a taxpayer by visiting our online tax toolkit at www.taxtoolkit.irs.gov. You can get updates on hot tax topics by visiting our YouTube channel at www.youtube.com/tasnta and our Facebook page at www.facebook.com/YourVoiceAtIRS, or by following our tweets at www.twitter.com/YourVoiceAtIRS.

Internet.

You can access the IRS website at IRS.gov 24 hours a day, 7 days a week to:

- Download forms, including talking tax forms, instructions and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- Use the online Internal Revenue Code, Regulations, or other official guidance.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Sign up to receive local and national tax news by email.

Phone.
Many services are available by phone.

- Ordering forms, instructions, and publications. Call 1-800-TAX-FORM (1-800-829-3676) to order current-year forms, instructions, and publications, and prior-year forms and instructions. You should receive your order within 10 days.
- 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.

Mail.
You can send your order for forms, instructions, and publications to the address below. You should receive a response within 10 days after your request is received.

Internal Revenue Service
1201 N. Mitsubishi Motorway
Bloomington, IL 61705-6613

DVD for tax products.
You can order Publication 1796, IRS Tax Products DVD, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms, instructions, and publications.
- Tax Map: An electronic research tool and finding aid.

- Tax law frequently asked questions.
- Tax Topics from the IRS telephone response system.
- Internal Revenue Code—Title 26 of the U.S. Code.
- Fill-in, print, and save features for most tax forms.
- Internal Revenue Bulletins.
- Toll-free and email technical support.
- Two releases during the year.

-The first release will ship the beginning of January 2012.

-The final release will ship the beginning of March 2012.

Purchase the DVD from National Technical Information Service (NTIS) at *www.irs.gov/cdorders* for $30 (no handling fee) or call 1-877-233-6767 toll free to buy the DVD for $30 (plus a $6 handling fee).

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

■

Form **5578**

(Rev. August 2013)

Department of the Treasury
Internal Revenue Service

Annual Certification of Racial Nondiscrimination for a Private School Exempt From Federal Income Tax

► **Information about Form 5578 and its instructions is at *www.irs.gov/form5578.***

(For use by organizations that do not file Form 990 or Form 990-EZ)

OMB No. 1545-0213

Open to Public Inspection

For IRS Use Only ►

For the period beginning , and ending ,

1a Name of organization that operates, supervises, and/or controls school(s).

1b Employer identification number

Address (number and street or P.O. box no., if mail is not delivered to street address) | Room/suite

City or town, state, and ZIP + 4 (If foreign address, list city or town, state or province, and country. Include postal code.)

2a Name of central organization holding group exemption letter covering the school(s). (If same as 1a above, write "Same" and complete 2c.) If the organization in 1a holds an individual exemption letter, write "Not Applicable."

2b Employer identification number

Address (number and street or P.O. box no., if mail is not delivered to street address) | Room/suite

2c Group exemption number (see instructions under *Definitions*)

City or town, state, and ZIP + 4 (If foreign address, list city or town, state or province, and country. Include postal code.)

3a Name of school. (If more than one school, write "See Attached," and attach a list of the names, complete addresses, including postal codes, and employer identification numbers of the schools.) If same as 1a, write "Same."

3b Employer identification number, if any

Address (number and street or P.O. box no., if mail is not delivered to street address) | Room/suite

City or town, state, and ZIP + 4 (If foreign address, list city or town, state or province, and country. Include postal code.)

Under penalties of perjury, I hereby certify that I am authorized to take official action on behalf of the above school(s) and that to the best of my knowledge and belief the school(s) has (have) satisfied the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50, 1975-2 C.B. 587, for the period covered by this certification.

(Signature) | (Type or print name and title.) | (Date)

General Instructions

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

Note. This form is open to public inspection.

Future Developments

For the latest information about developments related to Form 5578 and its instructions, such as legislation enacted after they were published, go to *www.irs.gov/form5578.*

Purpose of Form

Form 5578 may be used by organizations that operate tax-exempt private schools to provide the Internal Revenue Service with the annual certification of racial nondiscrimination required by Rev. Proc. 75-50 (the relevant part of which is reproduced in these instructions).

Who Must File

Every organization that claims exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code and that operates, supervises, or controls a private school(s) must file a certification of racial nondiscrimination. If an organization is required to file Form 990, Return of Organization Exempt From Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt From Income Tax, either as a separate return or as part of a group return, the certification must be made on Schedule E (Form 990 or 990-EZ), Schools, rather than on this form.

An authorized official of a central organization may file one form to certify for the school activities of subordinate organizations that would otherwise be required to file on an individual basis, but only if the central organization has enough control over the schools listed on the form to ensure that the schools maintain a racially nondiscriminatory policy as to students.

Definitions

A *racially nondiscriminatory policy as to students* means that the school admits the students of any race to all the rights, privileges, programs, and activities generally accorded or made available to students at that school and that the school does not discriminate on the basis of race in the administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs.

The IRS considers discrimination on the basis of race to include discrimination on the basis of color or national or ethnic origin.

A *school* is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes primary, secondary, preparatory, or high schools and colleges and universities, whether operated as a separate legal entity or as an activity of a church or other organization described in section 501(c)(3). The term also includes preschools and any other organization that is a school as defined in section 170(b)(1)(A)(ii).

A *central organization* is an organization that has one or more subordinates under its general supervision or control. A subordinate is a chapter, local, post, or other unit of a central organization. A central organization may also be a subordinate, as in the case of a state organization that has subordinate units and is itself affiliated with a national organization.

The *group exemption number (GEN)* is a four-digit number issued to a central organization by the IRS. It identifies a central organization that has received a ruling from the IRS recognizing on a group basis the exemption from federal income tax of the central organization and its covered subordinates.

When To File

Under Rev. Proc. 75-50, a certification of racial nondiscrimination must be filed annually by the 15th day of the 5th month following the end of the organization's calendar year or fiscal period.

Where To File

Mail Form 5578 to the Department of the Treasury, Internal Revenue Service Center, Ogden, UT 84201-0027.

Certification Requirement

Section 4.06 of Rev. Proc. 75-50 requires an individual authorized to take official action on behalf of a school that claims to be racially nondiscriminatory as to students to certify annually, under penalties of perjury, that to the best of his or her knowledge and belief the school has satisfied the applicable requirements of sections 4.01 through 4.05 of the Revenue Procedure, reproduced below:

Rev. Proc. 75-50

Section 4.01, Organizational Requirements. A school must include a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has a racially nondiscriminatory policy as to students and therefore does not discriminate against applicants and students on the basis of race, color, and national or ethnic origin.

Section 4.02, Statement of Policy. Every school must include a statement of its racially nondiscriminatory policy as to students in all its brochures and catalogues dealing with student admissions, programs, and scholarships. A statement substantially similar to the Notice described in paragraph (a) of subsection 1 of section 4.03, *infra,* will be acceptable for this purpose. Further, every school must include a reference to its racially nondiscriminatory policy in other written advertising that it uses as a means of informing prospective students of its programs. The following references will be acceptable:

The (name) school admits students of any race, color, and national or ethnic origin.

Section 4.03, Publicity. The school must make its racially nondiscriminatory policy known to all segments of the general community served by the school.

1. The school must use one of the following two methods to satisfy this requirement:

(a) The school may publish a notice of its racially nondiscriminatory policy in a newspaper of general circulation that serves all racial segments of the community. This publication must be repeated at least once annually during the period of the school's solicitation for students or, in the absence of a solicitation program, during the school's registration period. Where more than one community is served by a school, the school may publish its notice in those newspapers that are reasonably likely to be read by all racial segments of the communities that it serves. The notice must appear in a section of the newspaper likely to be read by prospective students and their families and it must occupy at least three column inches. It must be captioned in at least 12 point boldface type as a notice of nondiscriminatory policy as to students, and its text must be printed in at least 8 point type. The following notice will be acceptable:

Notice Of Nondiscriminatory Policy As To Students

The (name) school admits students of any race, color, national and ethnic origin to all the rights, privileges, programs, and activities generally accorded or made available to students at the school. It does not discriminate on the basis of race, color, national and ethnic origin in administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs.

(b) The school may use the broadcast media to publicize its racially nondiscriminatory policy if this use makes such nondiscriminatory policy known to all segments of the general community the school serves. If this method is chosen, the school must provide documentation that the means by which this policy was communicated to all segments of the general community was reasonably expected to be effective. In this case, appropriate documentation would include copies of the tapes or script used and records showing that there was an adequate number of announcements, that they were made during hours when the announcements were likely to be communicated to all segments of the general community, that they were of sufficient duration to convey the message clearly, and that they were broadcast on radio or television stations likely to be listened to by substantial numbers of members of all racial segments of the general community. Announcements must be made during the period of the school's solicitation for students or, in the absence of a solicitation program, during the school's registration period.

Communication of a racially nondiscriminatory policy as to students by a school to leaders of racial groups as the sole means of publicity generally will not be considered effective to make the policy known to all segments of the community.

2. The requirements of subsection 1 of this section will not apply when one of the following paragraphs applies:

(a) If for the preceding 3 years the enrollment of a parochial or other church-related school consists of students at least 75% of whom are members of the sponsoring religious denomination or unit, the school may make known its racially nondiscriminatory policy in whatever newspapers or circulars the religious denomination or unit utilizes in the communities from which the students are drawn. These newspapers and circulars may be those distributed by a particular religious denomination or unit or by an association that represents a number of religious organizations of the same denomination. If, however, the school advertises in newspapers of general circulation in the community or communities from which its students are drawn and paragraphs (b) and (c) of this subsection are not applicable to it, then it must comply with paragraph (a) of subsection 1 of this section.

(b) If a school customarily draws a substantial percentage of its students nationwide or world-wide or from a large geographic section or sections of the United States and follows a racially nondiscriminatory policy as to students, the publicity requirement may be satisfied by complying with section 4.02, *supra*. Such a school may demonstrate that it follows a racially nondiscriminatory policy within the meaning of the preceding sentence either by showing that it currently enrolls students of racial minority groups in meaningful numbers or, when minority students are not enrolled in meaningful numbers, that its promotional activities and recruiting efforts in each geographic area were reasonably designed to inform students of all racial segments in the general communities within the area of the availability of the school. The question whether a school satisfies the preceding sentence will be determined on the basis of the facts and circumstances of each case.

(c) If a school customarily draws its students from local communities and follows a racially nondiscriminatory policy as to students, the publicity requirement may be satisfied by complying with section 4.02, *supra*. Such a school may demonstrate that it follows a racially nondiscriminatory policy within the meaning of the preceding sentence by showing that it currently enrolls students of racial minority groups in meaningful numbers. The question whether a school satisfies the preceding sentence will be determined on the basis of the facts and circumstances of each case. One of the facts and circumstances that the Service will consider is whether the school's promotional activities and recruiting efforts in each area were reasonably designed to inform students of all racial segments in the general communities within the area of the availability of the school. The Service recognizes that the failure by a school drawing its students from local communities to enroll racial minority group students may not necessarily indicate the absence of a racially nondiscriminatory policy as to students when there are relatively few or no such students in these communities. Actual enrollment is, however, a meaningful indication of a racially nondiscriminatory policy in a community in which a public school or schools became subject to a desegregation order of a federal court or otherwise expressly became obligated to implement a desegregation plan under the terms of any written contract or other commitment to which any federal agency was a party.

The Service encourages schools to satisfy the publicity requirement by the methods described in subsection 1 of this section, regardless of whether a school considers itself within subsection 2, because it believes these methods to be the most effective to make known a school's racially nondiscriminatory policy. In this regard it is each school's responsibility to determine whether paragraph (a), (b), or (c) of subsection 2 applies to it. On audit, a school must be prepared to demonstrate that the failure to publish its racially nondiscriminatory policy in accordance with subsection 1 of this section was justified by the application to it of paragraph (a), (b), or (c) of subsection 2. Further, a school must be prepared to demonstrate that it has publicly disavowed or repudiated any statements purported to have been made on its behalf (after November 6, 1975) that are contrary to its publicity of a racially nondiscriminatory policy as to students, to the extent that the school or its principal official were aware of such statements.

Section 4.04, Facilities and Programs. A school must be able to show that all of its programs and facilities are operated in a racially nondiscriminatory manner.

Section 4.05, Scholarship and Loan Programs. As a general rule, all scholarship or other comparable benefits procurable for use at any given school must be offered on a racially nondiscriminatory basis. Their availability on this basis must be known throughout the general community being served by the school and should be referred to in the publicity required by this section in order for that school to be considered racially nondiscriminatory as to students. . . . scholarships and loans that are made pursuant to financial assistance programs favoring members of one or more racial minority groups that are designed to promote a school's racially nondiscriminatory policy will not adversely affect the school's exempt status. Financial assistance programs favoring members of one or more racial groups that do not significantly derogate from the school's racially nondiscriminatory policy similarly will not adversely affect the school's exempt status.

How To Get Tax Help

Internet

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

• Download forms, including talking tax forms, instructions, and publications.

- Order IRS products.
- Research your tax questions.
- Search publications by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Sign up to receive local and national tax news by email. To subscribe, visit *www.irs.gov/eo.*

By Phone

You can order forms and publications by calling 1-800-TAX-FORM (1-800-829-3676). You can also get most forms and publications at your local IRS office. 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 thru Friday.

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.

The organization is 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. The rules governing the confidentiality of this form are covered in section 6104.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is 3 hours and 44 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making this form simpler, we would be happy to hear from you. You can send your comments to the Internal Revenue Service, Tax Forms and Publications Division, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send the form to this address. Instead, see *Where To File.*

Internal Revenue Service
Tax Exempt and Government Entities
Exempt Organizations

IRS

tax guide for

Churches and Religious Organizations

benefits and responsibilities under the federal tax law

Congress has enacted special tax laws applicable to churches, religious organizations, and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business.

The Internal Revenue Service (IRS) offers this quick reference guide of federal tax law and procedures for churches and religious organizations to help them voluntarily comply with tax rules. The contents of this publication reflect the IRS interpretation of tax laws enacted by Congress, Treasury regulations, and court decisions. The information given is not comprehensive, however, and does not cover every situation. Thus, it is not intended to replace the law or be the sole source of information. The resolution of any particular issue may depend on the specific facts and circumstances of a given taxpayer. In addition, this publication covers subjects on which a court may have made a decision more favorable to taxpayers than the interpretation by the IRS. Until these differing interpretations are resolved by higher court decisions, or in some other way, this publication will present the interpretation of the IRS.

For more detailed tax information, the IRS has assistance programs and tax information products for churches and religious organizations, as noted in the back of this publication. Most IRS publications and forms can be downloaded from the IRS Web site at www.irs.gov, or ordered by calling toll-free (800) 829-3676. Specialized information can be accessed through the Exempt Organizations (EO) Web site under the IRS Tax Exempt and Government Entities division via www.irs.gov/eo or by calling EO Customer Account Services toll-free at (877) 829-5500.

The IRS considers this publication a living document, one that will be revised to take into account future developments and feedback. Comments on the publication may be submitted to the IRS at the following address:

Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224
Attn: T:EO:CE&O

Table of Contents

Introduction

This publication explains the benefits and the responsibilities under the federal tax system for churches and religious organizations. The term church *is found, but not specifically defined, in the Internal Revenue Code (IRC). The term is not used by all faiths; however, in an attempt to make this publication easy to read, we use it in its generic sense as a place of worship including, for example, mosques and synagogues. With the exception of the special rules for church audits, the use of the term church throughout this publication also includes conventions and associations of churches as well as* integrated auxiliaries of a church.

Because special tax rules apply to churches, it is important to distinguish churches from other religious organizations. Therefore, when this publication uses the term "religious organizations," it is not referring to churches or integrated auxiliaries. Religious organizations that are not churches typically include nondenominational ministries, interdenominational and ecumenical organizations, and other entities whose principal purpose is the study or advancement of religion.

Churches and religious organizations may be legally organized in a variety of ways under state law, such as unincorporated associations, nonprofit corporations, corporations sole, and charitable trusts.

Certain terms used throughout this publication—church, integrated auxiliary of a church, minister, and IRC section 501(c)(3)— are defined in the Glossary *on page 23.*

Tax-Exempt Status

Churches and religious organizations, like many other charitable organizations, qualify for exemption from federal income tax under IRC section 501(c)(3) and are generally eligible to receive tax-deductible contributions. To qualify for tax-exempt status, such an organization must meet the following requirements (covered in greater detail throughout this publication):

- the organization must be organized and operated exclusively for religious, educational, scientific, or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Recognition of Tax-Exempt Status

Automatic Exemption for Churches

Churches that meet the requirements of IRC section 501(c)(3) are automatically considered tax exempt and are not required to apply for and obtain recognition of tax-exempt status from the IRS.

Although there is no requirement to do so, many churches seek recognition of tax-exempt status from the IRS because such recognition assures church leaders, members, and contributors that the church is recognized as exempt and qualifies for related tax benefits. For example, contributors to a church that has been recognized as tax exempt would know that their contributions generally are tax-deductible.

Church Exemption Through a Central/Parent Organization

A church with a parent organization may wish to contact the parent to see if it has a *group ruling*. If the parent holds a group ruling, then the IRS may already recognize the church as tax exempt. Under the group exemption process, the parent organization becomes the holder of a group ruling that identifies other affiliated churches or other affiliated organizations. A church is recognized as tax exempt if it is included in a list provided by the parent organization. If the church or other affiliated organization is included on such a list, it does not need to take further action to obtain recognition of tax-exempt status.

An organization that is not covered under a group ruling should contact its parent organization to see if it is eligible to be included in the parent's application for the group ruling. For general information on the group exemption process, see Publication 4573, *Group Exemptions,* and Revenue Procedure 80-27, 1980-1 C.B. 677.

Religious Organizations

Unlike churches, religious organizations that wish to be tax exempt generally must apply to the IRS for tax-exempt status unless their gross receipts do not normally exceed $5,000 annually.

Applying for Tax-Exempt Status

Employer Identification Number (EIN)

Every tax-exempt organization, including a church, should have an employer identification number (EIN), whether or not the organization has any employees. There are many instances in which an EIN is necessary. For example, a church needs an EIN when it opens a bank account, in order to be listed as a subordinate in a group ruling, or if it files returns with the IRS (e.g., Forms W-2, 1099, 990-T).

An organization may obtain an EIN by filing Form S-4, *Application for Employer Identification Number*, in

accordance with the instructions. If the organization is submitting IRS Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* (see below), Form SS-4 should be included with the application.

Application Form

Organizations, including churches and religious organizations, applying for recognition as tax exempt under IRC section 501(c)(3) must use Form 1023.

A religious organization must submit its application within 27 months from the end of the month in which the organization is formed in order to be considered tax exempt and qualified to receive deductible contributions as of the date the organization was formed. On the other hand, a church may obtain recognition of exemption from the date of its formation as a church, even though that date may be prior to 27 months from the end of the month in which its application is submitted.

Cost for applying for exemption. The IRS is required to collect a non-refundable fee from any organization seeking a determination of tax-exempt status under IRC section 501(c)(3). Although churches are not required by law to file an application for exemption, if they choose to do so voluntarily, they are required to pay the fee for determination.

The fee must be submitted with Form 1023; otherwise, the application will be returned to the submitter. Fees change periodically. The most recent user fee can be found at the Exempt Organizations (EO) Web site under the IRS Tax Exempt and Government Entities division via www.irs.gov/eo (key word "user fee") or by calling EO Customer Account Services toll-free at (877) 829-5500.

IRS Approval of Exemption Application

If the application for tax-exempt status is approved, the IRS will notify the organization of its status, any requirement to file an annual information return, and its eligibility to receive deductible contributions. The IRS does not assign a special number or other identification as evidence of an organization's tax-exempt status.

Public Listing of Tax-Exempt Organizations

The IRS lists organizations that are qualified to receive tax-deductible contributions in IRS Publication 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*. This publication is sold to the public through the Superintendent of Documents, U.S. Government Printing Office, Washington, DC. Publication 78 can also be downloaded from the IRS Web site at www.irs.gov. Note that not every organization that is eligible to receive tax-deductible contributions is listed in Publication 78. For example, churches that have not applied for recognition of tax-exempt status are not included in the publication. Only the parent organization in a group ruling is included by name in Publication 78.

If you have questions about listing an organization, correcting an erroneous entry, or deleting a listing in Publication 78, contact EO Customer Account Services toll-free at (877) 829-5500.

Jeopardizing Tax-Exempt Status

All IRC section 501(c)(3) organizations, including churches and religious organizations, must abide by certain rules:

- their net earnings may not inure to any private shareholder or individual,
- they must not provide a substantial benefit to private interests,
- they must not devote a substantial part of their activities to attempting to influence legislation,
- they must not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

Inurement and Private Benefit

Inurement to Insiders

Churches and religious organizations, like all exempt organizations under IRC section 501(c)(3), are prohibited from engaging in activities that result in inurement of the church's or organization's income or assets to insiders (i.e., persons having a personal and private interest in the activities of the organization). *Insiders* could include the minister, church board members, officers, and in certain circumstances, employees. Examples of prohibited inurement include the payment of dividends, the payment of unreasonable compensation to insiders, and transferring property to insiders for less than fair market value. The prohibition against inurement to insiders is absolute; therefore, any amount of inurement is, potentially, grounds for loss of tax-exempt status. In addition, the insider involved may be subject to excise tax. See the following section on *Excess benefit transactions*. Note that prohibited inurement does not include reasonable payments for services rendered, payments that further tax-exempt purposes, or payments made for the fair market value of real or personal property.

Excess benefit transactions. In cases where an IRC section 501(c)(3) organization provides an excess economic benefit to an insider, both the organization and the insider have engaged in an *excess benefit transaction*. The IRS may impose an excise tax on any insider who improperly benefits from an excess benefit transaction, as well as on organization managers who participate in such a transaction knowing that it is improper. An insider who benefits from an excess benefit transaction is also required to return the excess benefits to the organization. Detailed rules on excess benefit transactions are contained in the Code of Federal Regulations, Title 26, sections 53.4958-0 through 53.4958-8.

Private Benefit

An IRC section 501(c)(3) organization's activities must be directed exclusively toward charitable, educational, religious, or other exempt purposes. Such an organization's activities may not serve the private interests of any individual or organization. Rather, beneficiaries of an organization's activities must be recognized objects of charity (such as the poor or the distressed) or the community at large (for example, through the conduct of religious services or the promotion of religion). Private benefit is different from inurement to insiders. Private benefit may occur even if the persons benefited are not insiders. Also, private benefit must be substantial in order to jeopardize tax-exempt status.

Substantial Lobbying Activity

In general, no organization, including a church, may qualify for IRC section 501(c)(3) status if a substantial part of its activities is attempting to influence legislation (commonly known as lobbying). An IRC section 501(c)(3) organization may engage in some lobbying, but too much lobbying activity risks loss of tax-exempt status.

Legislation includes action by Congress, any state legislature, any local council, or similar governing body, with respect to acts, bills, resolutions, or similar items (such as legislative confirmation of appointive offices), or by the public in a referendum, ballot initiative, constitutional amendment, or similar procedure. It does not include actions by executive, judicial, or administrative bodies.

A church or religious organization will be regarded as *attempting to influence legislation* if it contacts, or urges the public to contact, members or employees of a legislative body for the purpose of proposing, supporting, or opposing legislation, or if the organization advocates the adoption or rejection of legislation.

Churches and religious organizations may, however, involve themselves in issues of public policy without the activity being considered as lobbying. For example, churches may conduct educational meetings, prepare and distribute educational materials, or otherwise consider public policy issues in an educational manner without jeopardizing their tax-exempt status.

Measuring Lobbying Activity

Substantial part test. Whether a church's or religious organization's attempts to influence legislation constitute a substantial part of its overall activities is determined on the basis of all the pertinent facts and circumstances in each case. The IRS considers a variety of factors, including the time devoted (by both compensated and volunteer workers) and the expenditures devoted by the organization to the activity, when determining whether the lobbying activity is substantial. Churches must use the substantial part test since they are not eligible to use the expenditure test described in the next section.

Under the , a church or religious organization that conducts excessive lobbying activity in any taxable year may lose its tax-exempt status, resulting in all of its income being subject to tax. In addition, a religious organization is subject to an excise tax equal to five percent of its lobbying expenditures for the year in which it ceases to qualify for exemption. Further, a tax equal to five percent of the lobbying expenditures for the year may be imposed against organization managers, jointly and severally, who agree to the making of such expenditures knowing that the expenditures would likely result in loss of tax-exempt status.

Expenditure test. Although churches are not eligible, religious organizations may elect the expenditure test under IRC section 501(h) as an alternative method for measuring lobbying activity. Under the expenditure test, the extent of an organization's lobbying activity will not jeopardize its tax-exempt status, provided its expenditures, related to such activity, do not normally exceed an amount specified in IRC section 4911. This limit is generally based upon the size of the organization and may not exceed $1,000,000.

Religious organizations electing to use the expenditure test must file IRS Form 5768, *Election/Revocation of Election by an Eligible IRC Section 501(c)(3) Organization To Make Expenditures To Influence Legislation*, at any time during the tax year for which it is to be effective. The election remains in effect for succeeding years unless it is revoked by the organization. Revocation of the election is effective beginning with the year following the year in which the revocation is filed. Religious organizations may wish to consult their tax advisors to determine their eligibility for, and the advisability of, electing the expenditure test.

Under the , a religious organization that engages in excessive lobbying activity over a four-year period may lose its tax-exempt status, making all of its income for that period subject to tax. Should the organization exceed its lobbying expenditure dollar limit in a particular year, it must pay an excise tax equal to 25 percent of the excess.

Political Campaign Activity

Under the Internal Revenue Code, all IRC section 501(c)(3) organizations, including churches and religious organizations, are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office. Contributions to political campaign funds or public statements of position (verbal or written) made by or on behalf of the organization in favor of or in opposition to any candidate for public office clearly violate the prohibition against political campaign activity. Violation of this prohibition may result in denial or revocation of tax-exempt status and the imposition of certain excise tax.

Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including the presentation of public forums and the publication of voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not constitute prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that: (a) would favor one candidate over another; (b) oppose a candidate in some manner; or (c) have the effect of favoring a candidate or group of candidates, will constitute prohibited participation or intervention.

Individual Activity by Religious Leaders

The political campaign activity prohibition is not intended to restrict free expression on political matters by leaders of churches or religious organizations speaking for themselves, as *individuals.* Nor are leaders prohibited from speaking about important issues of public policy. However, for their organizations to remain tax exempt under IRC section 501(c)(3), religious leaders cannot make partisan comments in official organization publications or at official church functions. To avoid potential attribution of their comments outside of church functions and publications, religious leaders who speak or write in their individual capacity are encouraged to clearly indicate that their comments are personal and not intended to represent the views of the organization. The following are examples of situations involving endorsements by religious leaders.

Example 1: Minister A is the minister of Church J, a section 501(c)(3) organization, and is well known in the community. With their permission, Candidate T publishes a full-page ad in the local newspaper listing five prominent ministers who have personally endorsed Candidate T, including Minister A. Minister A is identified in the ad as the minister of Church J. The ad states, "Titles and affiliations of each individual are provided for identification purposes only." The ad is paid for by Candidate T's campaign committee. Since the ad was not paid for by Church J, the ad is not otherwise in an official publication of Church J, and the endorsement is made by Minister A in a personal capacity, the ad does not constitute political campaign intervention by Church J.

Example 2: Minister B is the minister of Church K, a section 501(c)(3) organization, and is well known in the community. Three weeks before the election, he attends a press conference at Candidate V's campaign headquarters and states that Candidate V should be reelected. Minister B does not say he is speaking on behalf of Church K. His endorsement is reported on the front page of the local newspaper and he is identified in the article as the minister of Church K. Because Minister B did not make the endorsement at an official church function, in an official church publication or otherwise use the church's assets, and did not state that he was speaking as a representative of Church K, his actions do not constitute political campaign intervention by Church K.

Example 3: Minister C is the minister of Church I, a section 501(c)(3) organization.. Church I, publishes a monthly church newsletter that is distributed to all church members. In each issue, Minister C has a column titled "My Views." The month before the election, Minister C states in the "My Views" column, "It is my personal opinion that Candidate U should be reelected." For that one issue, Minister C pays from his personal funds the portion of the cost of the newsletter attributable to the "My Views" column. Even though he paid part of the cost of the newsletter, the newsletter is an official publication of the church. Because the endorsement appeared in an official publication of Church I, it constitutes political campaign intervention by Church I.

Example 4: Minister D is the minister of Church M, a section 501(c)(3) organization. During regular services of Church M shortly before the election, Minister D preached on a number of issues, including the importance of voting in the upcoming election, and concluded by stating, "It is important that you all do your duty in the election and vote for Candidate W." Because Minister D's remarks indicating support for Candidate W were made during an official church service, they constitute political campaign intervention by Church M.

Issue Advocacy vs. Political Campaign Intervention

Like other section 501(c)(3) organizations, some churches and religious organizations take positions on public policy issues, including issues that divide candidates in an election for public office. However, section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. A statement can identify a candidate not only by stating the candidate's name but also by other means such as showing a picture of the candidate, referring to political party affiliations, or other distinctive features of a candidate's platform or biography. All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention.

Key factors in determining whether a communication results in political campaign intervention include the following:

- whether the statement identifies one or more candidates for a given public office;
- whether the statement expresses approval or disapproval for one or more candidates' positions and/or actions;
- whether the statement is delivered close in time to the election;
- whether the statement makes reference to voting or an election;
- whether the issue addressed in the communication has been raised as an issue distinguishing candidates for a given office;
- whether the communication is part of an ongoing series of communications by the organization on the same issue that are made independent of the timing of any election; and
- whether the timing of the communication and identification of the candidate are related to a non-electoral event such as a scheduled vote on specific legislation by an officeholder who also happens to be a candidate for public office.

A communication is particularly at risk of political campaign intervention when it makes reference to candidates or voting in a specific upcoming election. Nevertheless, the communication must still be considered in context before arriving at any conclusions.

Example 1: Church O, a section 501(c)(3) organization, prepares and finances a full page newspaper advertisement that is published in several large circulation newspapers in State V shortly before an election in which Senator C is a candidate for nomination in a party primary. Senator C is the incumbent candidate in a party primary. The advertisement states that a pending bill in the United States Senate would provide additional opportunities for State V residents to participate in faith-based programs by providing funding to such church-affiliated programs. The advertisement ends with the statement "Call or write Senator C to tell him to vote for this bill, despite his opposition in the past." Funding for faith-based programs has not been raised as an issue distinguishing Senator C from any opponent. The bill is scheduled for a vote before the election. The advertisement identifies Senator C's position as contrary to O's position. Church O has not violated the political campaign intervention prohibition: The advertisement does not mention the election or the candidacy of Senator C or distinguish Senator C from any opponent. The timing of the advertising and the identification of Senator C are directly related to a vote on the identified legislation. The candidate identified, Senator C, is an officeholder who is in a position to vote on the legislation.

Example 2: Church R, a section 501(c)(3) organization, prepares and finances a radio advertisement urging an increase in state funding for faith-based education in State X, which requires a legislative appropriation. Governor E is the governor of State X. The radio advertisement is first broadcast on several radio stations in State X beginning shortly before an election in which Governor E is a candidate for re-election. The advertisement is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue. The advertisement cites numerous statistics indicating that faith-based education in State X is under funded. Although the advertisement does not say anything about Governor E's position on funding for faith-based education, it ends with "Tell Governor E what you think about our under-funded schools." In public appearances and campaign literature, Governor E's opponent has made funding of faith-based education an issue in the campaign by focusing on Governor E's veto of an income tax increase to increase funding for faith-based education. At the time the advertisement is broadcast, no legislative vote or other major legislative activity is scheduled in the State X legislature on state funding of faith-based education. Church R has violated the political campaign prohibition: The advertisement identifies Governor E, appears shortly before an election in which Governor E is a candidate, is not part of an ongoing series of substantially similar advocacy communications by Church R on the same issue, is not timed to coincide with a non-election event such as a legislative vote or other major legislative action on that issue, and takes a position on an issue that the opponent has used to distinguish himself from Governor E.

Example 3: Candidate A and Candidate B are candidates for the state senate in District W of State X. The issue of State X funding for a faith-based indigent hospital care in District W is a prominent issue in the campaign. Both candidates have spoken out on the issue. Candidate A supports funding such care; Candidate B opposes the project and supports increasing State X funding for public hospitals instead. P is the head of the board of elders at Church C, a section 501(c)(3) organization located in District W. At C's annual fundraising dinner in District W, which takes place in the month before the election, P gives a long speech about health care issues including the health care issues, including the issue of funding for faith-based programs. P does not mention the name of any candidate or any political party. However, at the end of the speech, P makes the following statement, "For those of you who care about quality of life in District W and the desire of our community for health care responsive to their faith, there is a very important choice coming up next month. We need more funding for health care. Increased public hospital funding will not make a difference. You have the power to respond to the needs of this community. Use that power when you go to the polls and cast your vote in the election for your state senator." C has violated the political campaign intervention prohibition as a result of P's remarks at C's official function shortly before the election, in which P referred to the upcoming election after stating a position on an issue that is a prominent issue in a campaign that distinguishes the candidates.

Inviting a Candidate to Speak

Depending on the facts and circumstances, a church or religious organization may invite political candidates to speak at its events without jeopardizing its tax-exempt status. Political candidates may be invited in their capacity as candidates, or individually (not as a candidate). Candidates may also appear without an invitation at organization events that are open to the public.

Speaking as a candidate. Like any other IRC section 501(c)(3) organization, when a candidate is invited to speak at a church or religious organization event as a political candidate, factors in determining whether the organization participated or intervened in a political campaign include the following:

- whether the church provides an equal opportunity to the political candidates seeking the same office,
- whether the church indicates any support of or opposition to the candidate. (This should be stated explicitly when the candidate is introduced and in communications concerning the candidate's appearance.)
- whether any political fundraising occurs
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Equal opportunity to participate. Like any other IRC section 501(c)(3) organization, in determining whether candidates are given an equal opportunity to participate, a church or religious organization should consider the nature of the event to which each candidate is invited, in addition to the manner of presentation. For example, a church or religious organization that invites one candidate to speak at its well attended annual banquet, but invites the opposing candidate to speak at a sparsely attended general meeting, will likely be found to have violated the political campaign prohibition, even if the manner of presentation for both speakers is otherwise neutral.

Public forum. Sometimes a church or religious organization invites several candidates to speak at a public forum. A public forum involving several candidates for public office may qualify as an exempt educational activity. However, if the forum is operated to show a bias for or against any candidate, then the forum would be prohibited campaign activity, as it would be considered intervention or participation in a political campaign. When an organization invites several candidates to speak at a forum, among the factors it should consider are:

- whether questions for the candidate are prepared and presented by an independent nonpartisan panel,
- whether the topics discussed by the candidates cover a broad range of issues that the candidates would address if elected to the office sought and are of interest to the public,
- whether each candidate is given an equal opportunity to present his or her views on the issues discussed,
- whether the candidates are asked to agree or disagree with positions, agendas, platforms or statements of the organization, and
- whether a moderator comments on the questions or otherwise implies approval or disapproval of the candidates.

A candidate may seek to reassure the organization that it is permissible for the organization to do certain things in connection with the candidate's appearance. An organization in this position should keep in mind that the candidate may not be familiar with the organization's tax-exempt status and that the candidate may be focused on compliance with the election laws that apply to the candidate's campaign rather than the federal tax law that applies to the organization. The organization will be in the best position to ensure compliance with the prohibition on political campaign intervention if it makes its own independent conclusion about its compliance with federal tax law.

The following are examples of situations where a church or religious organization invites a candidate(s) to speak before the congregation.

Example 1: Minister E is the minister of Church N, a section 501(c)(3) organization. In the month prior to the election, Minister E invited the three Congressional candidates for the district in which Church N is located to address the congregation, one each on three successive Sundays, as part of regular worship services. Each candidate was given an equal opportunity to address and field questions on a wide variety of topics from the congregation. Minister E's introduction of each candidate included no comments on their qualifications or any indication of a preference for any candidate. The actions do not constitute political campaign intervention by Church N.

Example 2: The facts are the same as in the preceding example except that there are four candidates in the race rather than three, and one of the candidates declines the invitation to speak. In the publicity announcing the dates for each of the candidate's speeches, Church N includes a statement that the order of the speakers was determined at random and the fourth candidate declined the church's invitation to speak. Minister E makes the same statement in his opening remarks at each of the meetings where one of the candidates is speaking. Church N's actions do not constitute political campaign intervention.

Example 3: Minister F is the minister of Church O, a section 501(c)(3) organization. The Sunday before the November election, Minister F invited Senate Candidate X to preach to her congregation during worship services. During his remarks, Candidate X stated, "I am asking not only for your votes, but for your enthusiasm and dedication, for your willingness to go the extra mile to get a very large turnout on Tuesday." Minister F invited no other candidate to address her congregation during the Senatorial campaign. Because these activities took place during official church services, they are by Church O. By selectively providing church facilities to allow Candidate X to speak in support of his campaign, Church O's actions constitute political campaign intervention.

Speaking as a non-candidate. Like any other IRC section 501(c)(3) organization, a church or religious organization may invite political candidates (including church members) to speak in a non-candidate capacity. For instance, a political candidate may be a public figure because he or she: (a) currently holds, or formerly held, public office; (b) is considered an expert in a non-political field; or (c) is a celebrity or has led a distinguished military, legal, or public service career. A candidate may choose to attend an event that is open to the public, such as a lecture, concert or worship service. The candidate's presence at a church-sponsored event does not, by itself, cause the organization to be involved in political campaign intervention. However, if the candidate is publicly recognized by the organization, or if the candidate is invited to speak, factors in determining whether the candidate's appearance results in political campaign intervention include the following:

- whether the individual speaks only in a non-candidate capacity,
- whether either the individual or any representative of the church makes any mention of his or her candidacy or the election,
- whether any campaign activity occurs in connection with the candidate's attendance,
- whether the individual is chosen to speak solely for reasons other than candidacy for public office,
- whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present, and
- whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

In addition, the church or religious organization should clearly indicate the capacity in which the candidate is appearing and should not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's attendance at the event.

Below are examples of situations where a public official appears at a church or religious organization.

Example 1: Church P, a section 501(c)(3) organization, is located in the state capital. Minister G customarily acknowledges the presence of any public officials present during services. During the state gubernatorial race, Lieutenant Governor Y, a candidate, attended a Wednesday evening prayer service in the church. Minister G acknowledged the Lieutenant Governor's presence in his customary manner, saying, "We are happy to have worshiping with us this evening Lieutenant Governor Y." Minister G made no reference in his welcome to the Lieutenant Governor's candidacy or the election. Minister G's actions do not constitute political campaign intervention by Church P.

Example 2: Minister H is the minister of Church Q, a section 501(c)(3) organization. Church Q is building a community center. Minister H invites Congressman Z, the representative for the district containing Church Q, to attend the groundbreaking ceremony for the community center. Congressman Z is running for reelection at the time. Minister H makes no reference in her introduction to Congressman Z's candidacy or the election. Congressman Z also makes no reference to his candidacy or the election and does not do any fundraising while at Church Q. Church Q has not intervened in a political campaign.

Example 3: Church X is a section 501(c)(3) organization. X publishes a member newsletter on a regular basis. Individual church members are invited to send in updates about their activities which are printed in each edition of the newsletter. After receiving an update letter from Member Q, X prints the following: "Member Q is running for city council in Metropolis." The newsletter does not contain any reference to this election or to Member Q's candidacy other than this statement of fact. Church X has not intervened in a political campaign.

Example 4: Mayor G attends a concert performed by a choir of Church S, a section 501(c)(3) organization, in City Park. The concert is free and open to the public. Mayor G is a candidate for reelection, and the concert takes place after the primary and before the general election. During the concert, S's minister addresses the crowd and says, "I am pleased to see Mayor G here tonight. Without his support, these free concerts in City Park would not be possible. We will need his help if we want these concerts to continue next year so please support Mayor G in November as he has supported us." As a result of these remarks, Church S has engaged in political campaign intervention.

Voter Education, Voter Registration and Get-Out-the-Vote Drives

Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a non-partisan manner. In addition, section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a non-partisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.

Like other IRC section 501(c)(3) organizations, some churches and religious organizations undertake voter education activities by distributing *voter guides*. Voter guides, generally, are distributed during an election campaign and provide information on how all candidates stand on various issues. These guides may be distributed with the purpose of educating voters; however, they may not be used to attempt to favor or oppose candidates for public elected office.

A careful review of the following facts and circumstances may help determine whether or not a church or religious organization's publication or distribution of voter guides constitutes prohibited political campaign activity:

- whether the candidates' positions are compared to the organization's position,

- whether the guide includes a broad range of issues that the candidates would address if elected to the office sought,
- whether the description of issues is neutral,
- whether all candidates for an office are included, and
- whether the descriptions of candidates' positions are either:
  - the candidates' own words in response to questions, or
  - a neutral, unbiased and complete compilation of all candidates' positions.

The following are examples of situations where churches distribute voter guides.

Example 1: Church R, a section 501(c)(3) organization, distributes a voter guide prior to elections. The voter guide consists of a brief statement from the candidates on each issue made in response to a questionnaire sent to all candidates for governor of State I. The issues on the questionnaire cover a wide variety of topics and were selected by Church R based solely on their importance and interest to the electorate as a whole. Neither the questionnaire nor the voter guide, through their content or structure, indicate a bias or preference for any candidate or group of candidates. Church R is not participating or intervening in a political campaign.

Example 2: Church S, a section 501(c)(3) organization, distributes a voter guide during an election campaign. The voter guide is prepared using the responses of candidates to a questionnaire sent to candidates for major public offices. Although the questionnaire covers a wide range of topics, the wording of the questions evidences a bias on certain issues. By using a questionnaire structured in this way, Church S is participating or intervening in a political campaign.

Example 3: Church T, a section 501(c)(3) organization, sets up a booth at the state fair where citizens can register to vote. The signs and banners in and around the booth give only the name of the church, the date of the next upcoming statewide election, and notice of the opportunity to register. No reference to any candidate or political party is made by volunteers staffing the booth or in the materials available in the booth, other than the official voter registration forms which allow registrants to select a party affiliation. Church T is not engaged in political campaign intervention when it operates this voter registration booth.

Example 4: Church C is a section 501(c)(3) organization. C's activities include educating its members on family issues involving moral values. Candidate G is running for state legislature and an important element of her platform is challenging the incumbent's position on family issues. Shortly before the election, C sets up a telephone bank to call registered voters in the district in which Candidate G is seeking election. In the phone conversations, C's representative tells the voter about the moral importance of family issues and asks questions about the voter's views on these issues. If the voter appears to agree with the incumbent's position, C's representative thanks the voter and ends the call. If the voter appears to agree with Candidate G's position, C's representative reminds the voter about the upcoming election, stresses the importance of voting in the election and offers to provide transportation to the polls. C is engaged in political campaign intervention when it conducts this get-out-the-vote drive.

Business Activity

The question of whether an activity constitutes participation or intervention in a political campaign may also arise in the context of a business activity of the church or religious organization, such as the selling or renting of mailing lists, the leasing of office space, or the acceptance of paid political advertising. (The tax treatment of income from unrelated business activities follows.) In this context, some of the factors to be considered in determining whether the church or religious organization has engaged in prohibited political campaign activity include the following:

- whether the good, service, or facility is available to the candidates on an equal basis,
- whether the good, service, or facility is available only to candidates and not to the general public,
- whether the fees charged are at the organization's customary and usual rates, and
- whether the activity is an ongoing activity of the organization or whether it is conducted only for the candidate.

Example 1: Church K is a section 501(c)(3) organization. It owns a building that has a large basement hall suitable for hosting dinners and receptions. For several years, Church K has made the hall available for rent to members of the public. It has standard fees for renting the hall based on the number of people in attendance, and a number of different organizations have rented the hall. Church K rents the hall on a first come, first served basis. Candidate P's campaign pays the standard fee for the dinner. Church K is not involved in political campaign intervention as a result of renting the hall to Candidate P for use as the site of a campaign fundraising dinner.

Example 2: Church L is a section 501(c)(3) organization. It maintains a mailing list of all of its members. Church L has never rented the mailing list to a third party. The campaign committee of Candidate Q, who supports funding for faith-based programs, approaches Church L. Candidate A's campaign committee offers to rent Church L's mailing list for a fee that is comparable to fees charged by other similar organizations. Church L rents the list to Candidate A's campaign committee, but declines similar requests from campaign committees of other candidates. Church L has intervened in a political campaign.

Web Sites: The Internet has become a widely used communications tool. Section 501(c)(3) organizations use their own web sites to disseminate statements and information. They also routinely link their web sites to web sites maintained by other organizations as a way of providing additional information that the organizations believe is useful or relevant to the public.

A web site is a form of communication. If an organization posts something on its web site that favors or opposes a candidate for public office, the organization will be treated the same as if it distributed printed material, oral statements or broadcasts that favored or opposed a candidate.

An organization has control over whether it establishes a link to another site. When an organization establishes a link to another web site, the organization is responsible for the consequences of establishing and maintaining that link, even if the organization does not have control over the content of the linked site. Because the linked content may change over time, an organization may reduce the risk of political campaign intervention by monitoring the linked content and adjusting the links accordingly.

Links to candidate-related material, by themselves, do not necessarily constitute political campaign intervention. All the facts and circumstances must be taken into account when assessing whether a link produces that result. The facts and circumstances to be considered include, but are not limited to, the context for the link on the organization's web site, whether all candidates are represented, any exempt purpose served by offering the link, and the directness of the links between the organization's web site and the web page that contains material favoring or opposing a candidate for public office.

Example 1: Church P, a section 501(c)(3) organization, maintains a web site that includes such information as biographies of its ministers, times of services, details of community outreach programs, and activities of members of its congregation. B, a member of the congregation of Church P, is running for a seat on the town council. Shortly before the election, Church P posts the following message on its web site, "Lend your support to B, your fellow parishioner, in Tuesday's election for town council." Church P has intervened in a political campaign on behalf of B.

Example 2: Church N, a section 501(c)(3) organization, maintains a web site that includes such information as staff listings; directions to the church; and descriptions of its community outreach programs, schedules of services, and school activities. On one page of the web site, Church N describes a particular type of treatment program for homeless veterans. This section includes a link to an article on the web site of O, a major national newspaper, praising Church N's treatment program for homeless veterans. The page containing the article on O's web site does not refer to any candidate or election and has no direct links to candidate or election information. Elsewhere on O's web site, there is a page displaying editorials that O has published. Several of the editorials endorse candidates in an election that has not yet occurred. Church N has not intervened in a political campaign by maintaining a link on O's web site because the link is provided for the exempt purpose of educating the public about its programs; the context for the link, the relationship between Church N and O and the arrangement of the links going from Church N's web site to the endorsement on O's web site do not indicate that Church N was favoring or opposing any candidate.

Example 3: Church M, a section 501(c)(3) organization, maintains a web site and posts an unbiased, nonpartisan voter guide that is prepared with the principles discussed on pages 12 and 13 of this publication. For each candidate covered in the voter guide, M includes a link to that candidate's official campaign web site. The links to the candidate web sites are presented on a consistent neutral basis for each candidate, with text saying "For more information on Candidate X, you may consult [URL]." M has not intervened in a political campaign because the links are provided for the exempt purpose of educating voters and are presented in a neutral, unbiased manner that includes all candidates for a particular office.

Consequences of Political Campaign Activity

When it participates in political campaign activity, a church or religious organization jeopardizes both its tax-exempt status under IRC section 501(c)(3) and its eligibility to receive tax-deductible contributions. In addition, it may become subject to an excise tax on its political expenditures. This *excise tax* may be imposed in addition to revocation, or it may be imposed instead of revocation. Also, the church or religious organization should correct the violation.

Excise tax. An initial tax is imposed on an organization at the rate of 10 percent of the political expenditures. Also, a tax at the rate of 2.5 percent of the expenditures is imposed against the organization managers (jointly and severally) who, without reasonable cause, agreed to the expenditures knowing they were political expenditures. The tax on management may not exceed $5,000 with respect to any one expenditure.

In any case in which an initial tax is imposed against an organization, and the expenditures are not corrected within the period allowed by law, an additional tax equal to 100 percent of the expenditures is imposed against the organization. In that case, an additional tax is also imposed against the organization managers (jointly and severally) who refused to agree to make the correction. The additional tax on management is equal to 50 percent of the expenditures and may not exceed $10,000 with respect to any one expenditure.

Correction. Correction of a political expenditure requires the recovery of the expenditure, to the extent possible, and establishment of safeguards to prevent future political expenditures.

Please note that a church or religious organization that engages in any political campaign activity also needs to determine whether it is in compliance with the appropriate federal, state or local election laws, as these may differ from the requirements under IRC section 501(c)(3).

Unrelated Business Income Tax (UBIT)

Net Income Subject to the UBIT

Churches and religious organizations, like other tax-exempt organizations, may engage in income-producing activities unrelated to their tax-exempt purposes, as long as the unrelated activities are not a substantial part of the organization's activities. However, the net income from such activities will be subject to the UBIT if the following three conditions are met:

- the activity constitutes a trade or business,
- the trade or business is regularly carried on, and
- the trade or business is not substantially related to the organization's exempt purpose. (The fact that the organization uses the income to further its charitable or religious purposes does not make the activity substantially related to its exempt purposes.)

Exceptions to UBIT

Even if an activity meets the above three criteria, the income may not be subject to tax if it meets one of the following exceptions: (a) substantially all of the work in operating the trade or business is performed by volunteers; (b) the activity is conducted by the organization primarily for the convenience of its members; or (c) the trade or business involves the selling of merchandise substantially all of which was donated.

In general, rents from real property, royalties, capital gains, and interest and dividends are not subject to the unrelated business income tax unless financed with borrowed money.

Examples of Unrelated Trade or Business Activities

Unrelated trade or business activities vary depending on types of activities, as shown below.

Advertising

Many tax-exempt organizations sell advertising in their publications or other forms of public communication. Generally, income from the sale of advertising is unrelated trade or business income. This may include the sale of advertising space in weekly bulletins, magazines or journals, or on church or religious organization web sites.

Gaming

Most forms of gaming, if regularly carried on, may be considered the conduct of an unrelated trade or business. This can include the sale of pull-tabs and raffles. Income derived from bingo games may be eligible for a special tax exception (in addition to the exception regarding uncompensated volunteer labor covered above), if the following conditions are met: (a) the bingo game is the traditional type of bingo (as opposed to instant bingo, a variation of pull-tabs); (b) the conduct of the bingo game is not an activity carried out by for-profit organizations in the local area; and (c) the operation of the bingo game does not violate any state or local law.

Sale of merchandise and publications

The sale of merchandise and publications (including the actual publication of materials) can be considered the conduct of an unrelated trade or business if the

items involved do not have a substantial relationship to the exempt purposes of the organization.

Rental income

Generally, income derived from the rental of real property and incidental personal property is excluded from unrelated business income. However, there are certain situations in which rental income may be unrelated business taxable income:

- if a church rents out property on which there is debt outstanding (for example, a mortgage note), the rental income may constitute unrelated debt-financed income subject to UBIT. (However, if a church or convention or association of churches acquires debt-financed land for use in its exempt purposes within 15 years of the time of acquisition, then income from the rental of the land may not constitute unrelated business income.)
- if personal services are rendered in connection with the rental, then the income may be unrelated business taxable income, or
- if a church charges for the use of the parking lot, the income may be unrelated business taxable income.

Parking lots

If a church owns a parking lot that is used by church members and visitors while attending church services, any parking fee paid to the church would not be subject to UBIT. However, if a church operates a parking lot that is used by members of the general public, parking fees would be taxable, as this activity would not be substantially related to the church's exempt purpose, and parking fees are not treated as rent from real property. If the church enters into a lease with a third party who operates the church's parking lot and pays rent to the church, such payments would not be subject to tax, as they would constitute rent from real property.

Whether an income-producing activity is an unrelated trade or business activity depends on all the facts and circumstances. For more information, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

Tax on Income-Producing Activities

If a church, or other exempt organization, has gross income of $1,000 or more for any taxable year from the conduct of any unrelated trade or business, it is required to file IRS Form 990-T, *Exempt Organization Business Income Tax Return*, for that year. If the church is part of a larger entity (such as a diocese), it must file a separate Form 990-T if it has a separate EIN. Form 990-T is due the l5th day of the 5th month following the end of the church's tax year. (IRC section 512(b)(12) provides a special rule for parishes and similar local units of a church. A specific deduction is provided, which is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by such parish or local unit of a church.) See Filing Requirements on page 22.

Download IRS publications and forms at www.irs.gov or order free through the IRS at (800) 829-3676.

Employment Tax

Generally, churches and religious organizations are required to withhold, report, and pay income and Federal Insurance Contributions Act (FICA) taxes for their employees. Employment tax includes income tax withheld and paid for an employee and FICA taxes withheld and paid on behalf of an employee. Substantial penalties may be imposed against an organization that fails to withhold and pay the proper employment tax. Whether a church or religious organization must withhold and pay employment tax depends upon whether the church's workers are employees. *Determination of worker status* is important. Several facts determine whether a worker is an employee. For an in-depth explanation and examples of the common law employer-employee relationship, see IRS Publication 15-A, *Employer's Supplemental Tax Guide*. If a church or a worker wants the IRS to determine whether the worker is an employee, the church or worker should file IRS Form SS-8, *Determination of Employee Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, with the IRS.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA)

FICA taxes consist of Social Security and Medicare taxes. Wages paid to employees of churches or religious organizations are subject to FICA taxes unless *one* of the following exceptions applies:

- wages are paid for services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his or her ministry, or by a member of a religious order in the exercise of duties required by such order,
- the church or religious organization pays the employee wages of less than $108.28 in a calendar year, or
- a church that is opposed to the payment of Social Security and Medicare taxes for religious reasons files IRS Form 8274, *Certification by Churches and Qualified Church Controlled Organizations Electing Exemption From Employer Social Security and Medicare Taxes*. Very specific timing rules apply to filing Form 8274. It must be filed before the *first* date on which the electing entity is required to file its first quarterly employment tax return. This election does not relieve the organization of its obligation to withhold income tax on wages paid to its employees. In addition, if such an election is made, affected employees must pay Self-Employment Contributions Act (SECA) tax. For further information, see Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*.

Withheld employee income tax and FICA taxes are reported on IRS Form 941, *Employer's Quarterly Federal Tax Return*. Some small employers are eligible to file an annual Form 944 instead of quarterly returns. For more information about employment tax, see IRS Publication 15, *Circular E, Employer's Tax Guide*, and IRS Publication 15-A, *Employer's Supplemental Tax Guide*. *See also*, IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*. See the instructions to Form 944 for more information.

Federal Unemployment Tax Act (FUTA)

Churches and religious organizations are not liable for FUTA tax. For further information on FUTA, see IRS Publication 15, *Circular E, Employer's Tax Guide*, and IRS Publication 15-A, *Employer's Supplemental Tax Guide*. See also, IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers.*

Special Rules for Compensation of Ministers

Withholding Income Tax for Ministers

Unlike other exempt organizations or businesses, a church is not required to withhold income tax from the compensation that it pays to its duly ordained, commissioned, or licensed ministers for performing services in the exercise of their ministry. An employee minister may, however, enter into a voluntary withholding agreement with the church by completing IRS Form W-4, *Employee's Withholding Allowance Certificate*. A church should report compensation paid to a minister on Form W-2, *Wage and Tax Statement*, if the minister is an employee, or on IRS Form 1099-MISC, *Miscellaneous Income*, if the minister is an independent contractor.

Parsonage or Housing Allowances

Generally, a minister's gross income does not include the fair rental value of a home (parsonage) provided, or a housing allowance paid, as part of the minister's compensation for services performed that are ordinarily the duties of a minister.

A minister who is furnished a *parsonage* may exclude from income the fair rental value of the parsonage, including utilities. However, the amount excluded cannot be more than the reasonable pay for the minister's services.

A minister who receives a *housing allowance* may exclude the allowance from gross income to the extent it is used to pay expenses in providing a home. Generally, those expenses include rent, mortgage payments, utilities, repairs, and other expenses directly relating to providing a home. If a minister owns a home, the amount excluded from the minister's gross income as a housing allowance is limited to the least of the following: (a) the amount actually used to provide a home; (b) the amount officially designated as a housing allowance; or (c) the fair rental value of the home. The minister's church or other qualified organization must designate the housing allowance pursuant to official action taken *in advance* of the payment. If a minister is employed and paid by a local congregation, a designation by a national church agency will not be effective. The local congregation must make the designation. A national church agency may make an effective designation for ministers it directly employs. If none of the minister's salary has been officially designated as a housing allowance, the full salary must be included in gross income.

The fair rental value of a parsonage or housing allowance is excludable from income only for income tax purposes. These amounts are *not* excluded in determining the minister's net earnings from self-employment for Self-Employment Contributions Act (SECA) tax purposes. Retired ministers who receive either a parsonage or housing allowance are not required to include such amounts for SECA tax purposes.

As mentioned above, a minister who receives a parsonage or rental allowance excludes that amount from his income. The portion of expenses allocable to the excludable amount is not deductible. This limitation, however, does not apply to interest on a home mortgage or real estate taxes, nor to the calculation of net earnings from self-employment for SECA tax purposes.

IRS Publication 517, *Social Security and Other Information for Members of the Clergy and Religious Workers*, has a detailed example of the tax treatment for a housing allowance and the related limitations on deductions. IRS Publication 525, *Taxable and Nontaxable Income*, has information on particular types of income for ministers.

Social Security and Medicare Taxes — Federal Insurance Contributions Act (FICA) vs. Self-Employment Contributions Act (SECA)

The compensation that a church or religious organization pays to its ministers for performing services in the exercise of ministry is not subject to FICA taxes. However, income that a minister earns in performing services in the exercise of his ministry is subject to SECA tax, unless the minister has timely applied for and received an exemption from SECA tax.

Payment of Employee Business Expenses

A church or religious organization is treated like any other employer as far as the tax rules regarding employee business expenses. The rules differ depending upon whether the expenses are paid through an accountable or non-accountable plan, and these plans determine whether the payment for these expenses is included in the employee's income.

Accountable Reimbursement Plan

An arrangement that an employer establishes to reimburse or advance employee business expenses will be an accountable plan if it meets three requirements: (1) involves a business connection; (2) requires the employee to substantiate expenses incurred; and (3) requires the employee to return any excess amounts.

Employees must provide the organization with sufficient information to identify the specific business nature of each expense and to substantiate each element of an expenditure. It is not sufficient for an employee to aggregate expenses into broad categories such as travel or to report expenses through the use of non-descriptive terms such as *miscellaneous business expenses*. Both the substantiation and the return of excess amounts must occur within a reasonable period of time.

Employee business expenses reimbursed under an accountable plan are: (a) excluded from an employee's gross income; (b) not required to be reported on the employee's IRS Form W-2, *Wage and Tax Statement*; and (c) exempt from the withholding and payment of wages subject to FICA taxes and income tax withholdings.

Non-accountable Reimbursement Plan

If the church or religious organization reimburses or advances the employee for business expenses, but the arrangement does not satisfy the three requirements of an accountable plan, the amounts paid to the employees are considered wages subject to FICA taxes and income tax withholding, if applicable, and are reportable on Form W-2. (Amounts paid to employee ministers are treated as wages reportable on Form W-2, but are not subject to FICA taxes or income tax withholding.)

For example, if a church or religious organization pays its secretary a $200 per month allowance to reimburse monthly business expenses the secretary incurs while conducting church or religious organization business, and the secretary is not required to substantiate the expenses or return any excess, then the entire $200 must be reported on Form W-2 as wages subject to FICA taxes and income tax withholding. In the same situation involving an employee-minister, the allowance must be reported on the minister's Form W-2, but no FICA or income tax withholding is required. For further information see IRS Publication 463, *Travel, Entertainment, Gift and Car Expenses*.

One common business expense reimbursement is for *automobile mileage*. If a church or religious organization pays a mileage allowance at a rate that is less than or equal to the federal standard rate, the amount of the expense is deemed substantiated. (Each year, the federal government establishes a standard mileage reimbursement rate.) There are no income or employment tax consequences to the reimbursed individual provided that the employee substantiates the time, place, and business purposes of the automobile mileage for which reimbursement is sought. Of course, reimbursement for automobile mileage incurred for personal purposes is includible in the individual's income.

If a church or religious organization reimburses automobile mileage at a rate exceeding the standard mileage rate, the excess is treated as paid under a non-accountable plan. This means that the excess is includible in the individual's income and is subject to the withholding and payment of income and employment taxes, if applicable.

In addition, any mileage reimbursement that is paid without requiring the individual to substantiate the time, place, and business purposes of each trip is included in the individual's income, regardless of the rate of reimbursement.

No income is attributed to an employee or a volunteer who uses an automobile owned by the church or religious organization to perform church-related work.

Recordkeeping Requirements

Books of Accounting and Other Types of Records

All tax-exempt organizations, including churches and religious organizations (regardless of whether tax-exempt status has been officially recognized by the IRS), are required to maintain books of accounting and other records necessary to justify their claim for exemption in the event of an audit. See Special Rules Limiting IRS Authority to Audit a Church on page 26. Tax-exempt organizations are also required to maintain books and records that are necessary to accurately file any federal tax and information returns that may be required.

There is no specific format for keeping records. However, the types of required records frequently include organizing documents (charter, constitution, articles of incorporation) and bylaws, minute books, property records, general ledgers, receipts and disbursements journals, payroll records, banking records, and invoices. The extent of the records necessary generally varies according to the type, size, and complexity of the organization's activities.

Length of Time to Retain Records

The law does not specify a *length of time* that records must be retained; however, the following guidelines should be applied in the event that the records may be material to the administration of any federal tax law.

Records of revenue and expenses, including payroll records.	Retain for at least four years after filing the return(s) to which they relate.
Records relating to acquisition and disposition of property (real and personal, including investments).	Retain for at least four years after the filing of the return for the year in which disposition occurs.

Filing Requirements

Information and Tax Returns — Forms to File and Due Dates

Churches and religious organizations may be required to report certain payments or information to the IRS. The following is a list of the most frequently required returns, who should use them, how they are used, and when they should be filed.

Returns	*Who Should Use Them*	*How They are Used*	*When to File*
Form W-2 ***Wage and Tax Statement*** **Form W-3** ***Transmittal of Wage and Tax Statement***	Organizations with employees.		Furnish each employee with a completed Form W-2 by January 31; and file all Forms W-2 and Form W-3 with the Social Security Administration (SSA) by the last day of February.
Form W-2G ***Certain Gaming Winnings*** For more information on reporting requirements for gaming activities, see IRS Publication 3079, *Gaming Publication for Tax-Exempt Organizations.*	Any charitable or religious organization, including a church, that sponsors a gaming event (raffles, bingo) must file Form W-2G when a participant wins a prize over a specific value amount.	The requirements for reporting and withholding depend on the type of gaming, the amount of winnings, and the ratio of winnings to the wager.	For each winner meeting the filing requirement, the church or religious organization must furnish Form W-2G by January 31; and file Copy A of Form W-2G with the IRS by February 28.
Form 941 ***Employer's Quarterly Federal Tax Return*** ***or*** Form 944 Employer's Annual Federal Tax Return	Small employers that have been notified by the IRS to file Form 944 (see form instructions) may use that form; other employers required to file must use Form 941.	Use Form 941 or 944 to report Social Security and Medicare taxes and income taxes withheld by the organization, and Social Security and Medicare taxes paid by the organization.	See form instructions for due dates.
Form 945 ***Annual Return of Withheld Federal Income Tax***		If a church or religious organization withholds income tax, including backup withholding, from non-payroll payments, it must file Form 945.	File Form 945 by January 31. This form is not required for those years in which there is no non-payroll tax liability.
Form 990 ***Return of Organization Exempt from Income Tax*** **Form 990-EZ** ***Short Form Return of Organization Exempt From Income Tax*** **Form 990-N (electronic postcard),** ***Electronic Notice for Tax Exempt Organizations Not Required to File Form 990 or 990-EZ.***	Generally, all religious organizations (see exceptions to file Form 990 below) must file Form 990, Form 990-EZ or Form 990-N.	For tax years 2008 through 2010, the thresholds for determining whether an organization should file Form 990, 990-EZ or 990-N will vary. See www.irs.gov/eo for the specific thresholds.	Form 990, 990-EZ or 990-N must be filed on or before the 15th day of the 5th month following the end of the organization's tax year. Form 990-N must be electronically filed.
	Exceptions to file Form 990, 990-EZ and 990-N The following is a list of some of the organizations that are not required to file Form 990, 990-EZ or 990-N. ■ Churches (as opposed to "religious organizations," defined earlier) ■ Inter-church organizations of local units of a church ■ Mission societies sponsored by or affiliated with one or more churches or church denomination, if more than half of the activities are conducted in, or directed at, persons in foreign countries ■ An exclusively religious activity of any religious order See the form instructions for a list of other organizations that are not required to file.		

Returns	*Who Should Use Them*	*How They are Used*	*When to File*
Form 990-T ***Exempt Organization Business Income Tax Return*** For more information on unrelated business income, see Unrelated Business Income Tax (UBIT) on page 16.	Churches and religious organizations.	Churches and religious organizations must file Form 990-T if they generate gross income from an unrelated business of $1,000 or more for a taxable year.	Form 990-T must be filed by the 15th day of the 5th month after the organization's accounting period ends (May 15 for a calendar year accounting period).
Form 990-W ***Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations***	Churches and religious organizations.	If the tax on unrelated business income is expected to be $500 or more, the church or religious organization must make estimated tax payments. Use Form 990-W to compute the estimated tax liability.	
Form 1096 ***Annual Summary and Transmittal of U.S. Information Returns***	Churches and religious organizations.	Use Form 1096 to transmit Forms 1099-MISC, W-2G, and certain other forms to the IRS.	Form 1096 must be filed by February 28 in the year following the calendar year in which the payments were made.
Form 1099 - MISC ***Miscellaneous Income*** See the *Instructions for* Form 1099-MISC for details.	Churches and religious organizations.	A church or religious organization must use Form 1099-MISC if it pays an unincorporated individual or entity $600 or more in any calendar year for one of the following payments: gross rents; commissions, fees, or other compensation paid to non-employees; prizes and awards; or other fixed and determinable income.	Churches or religious organizations must furnish each payee with a copy of Form 1099-MISC by January 31; and file Copy A of Form 1099-MISC with the IRS by February 28.
Form 5578 ***Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax*** For information on racial and ethnic nondiscriminatory policies, see Revenue Procedure 75-50, 1975-2 C.B. 587 at www.irs.gov.	A church or religious organization that operates a private school, whether separately incorporated or operated as part of its overall operations, that teaches secular subjects and generally complies with state law requirements for public education.	A church or religious organization must file Form 5578 to certify that it does not discriminate based on race or ethnic origin.	Form 5578 must be filed on or before the 15th day of the 5th month following the end of the organization's taxable year (May 15 for a calendar year). If an organization files Form 990 or Form 990-EZ, the certification must be made on Schedule A (Form 990 or Form 990-EZ).
	Note: It is not considered racially discriminatory for a parochial school to select students on the basis of membership in a religious denomination if membership in the denomination is open to all on a racially nondiscriminatory basis. Further, a seminary, or other purely religious school, that primarily teaches religious subjects usually with the purpose of training students for the ministry, is not subject to the racially nondiscriminatory requirements because it is considered to be a religious rather than an educational organization.		
Form 8282 ***Donee Information Return***	Churches and religious organizations.	A church or religious organization must file Form 8282 if it sells, exchanges, transfers, or otherwise disposes of certain non-cash donated property within three years of the date it originally received the donation. This applies to non-cash property that had an appraised value of more than $5,000 at time of donation.	The church or religious organization must file Form 8282 with the IRS within 125 days of date of disposition of the property; and furnish the original donor with a copy of the form.
Treasury Form 90.22.1, Report of Foreign Bank and Financial Accounts	See form instructions	See form instructions	See form instructions

Charitable Contributions— Substantiation and Disclosure Rules

Recordkeeping

A church or religious organization should be aware of the recordkeeping and substantiation rules imposed on donors of charities that receive certain quid pro quo contributions.

Recordkeeping Rules

A donor cannot claim a tax deduction for any contribution of cash, a check or other monetary gift made on or after January 1, 2007 unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or a letter) showing the name of the charity, the date of the contribution, and the amount of the contribution.

Substantiation Rules

A donor cannot claim a tax deduction for any single contribution of $250 or more unless the donor obtains a contemporaneous, written acknowledgment of the contribution from the recipient church or religious organization. A church or religious organization that does not acknowledge a contribution incurs no penalty; but without a written acknowledgment, the donor cannot claim a tax deduction. Although it is a donor's responsibility to obtain a written acknowledgment, a church or religious organization can assist the donor by providing a timely, written statement containing the following information:

- name of the church or religious organization,
- date of the contribution,
- amount of any cash contribution, and
- description (but not the value) of non-cash contributions.

In addition, the timely, written statement must contain one of the following:

- statement that no goods or services were provided by the church or religious organization in return for the contribution,
- statement that goods or services that a church or religious organization provided in return for the contribution consisted entirely of intangible religious benefits, or
- description and good faith estimate of the value of goods or services other than intangible religious benefits that the church or religious organization provided in return for the contribution.

The church or religious organization may either provide separate acknowledgments for each single contribution of $250 or more or one acknowledgment to substantiate several single contributions of $250 or more. Separate contributions are not aggregated for purposes of measuring the $250 threshold.

Disclosure Rules that Apply to Contributions

A contribution made by a donor in exchange for goods or services is known as a *quid pro quo* contribution. A donor may only take a contribution deduction to the extent that his or her contribution exceeds the fair market value of the goods and services the donor receives in return for the contribution. Therefore, donors need to know the value of the goods or services. A church or religious organization must provide a written statement to a donor who makes a payment exceeding $75 partly as a contribution and partly for goods and services provided by the organization.

Example 1: If a donor gives a church a payment of $100 and, in return, receives a ticket to an event valued at $40, this is a contribution, and only $60 is deductible by the donor ($100 - $40 = $60). Even though the deductible amount does not exceed $75, since the contribution the church received is in excess of $75, the church must provide the donor with a written disclosure statement. The statement must: (1) inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of money (and the fair market value of any property other than money) contributed by the donor over the value of goods or services provided by the church or religious organization; and (2) provide the donor with a good-faith estimate of the value of the goods or services.

The church or religious organization must provide the written disclosure statement with either the solicitation or the receipt of the contribution and in a manner that is likely to come to the attention of the donor. For example, a disclosure in small print within a larger document may not meet this requirement.

Exceptions to Disclosure Statement

A church or religious organization is not required to provide a disclosure statement for *quid pro quo* contributions when: (a) the goods or services meet the standards for *insubstantial value*; or (b) the only benefit received by the donor is an *intangible religious benefit*. Additionally, if the goods or services the church or religious organization provides are *intangible religious benefits* (examples follow), the acknowledgment for contributions of $250 or more does not need to describe those benefits.

Generally, intangible religious benefits are benefits provided by a church or religious organization that are not usually sold in commercial transactions outside a donative (gift) context.

Intangible religious benefits include:

- admission to a religious ceremony
- de minimis tangible benefits, such as wine used in religious ceremony

Benefits that are not intangible religious benefits include:

- tuition for education leading to a recognized degree
- travel services
- consumer goods

IRS Publication 1771, Charitable Contributions: Substantiation and Disclosure Requirements, provides more information on substantiation and disclosure rules.

Order Publication 1771 free through the IRS at (800) 829-3676.

Special Rules Limiting IRS Authority to Audit a Church

Tax Inquiries and Examinations of Churches

Congress has imposed special limitations, found in IRC section 7611, on how and when the IRS may conduct civil tax inquiries and examinations of churches. The IRS may only initiate a *church tax inquiry* if an appropriate high-level Treasury Department official reasonably believes, based on a written statement of the facts and circumstances, that the organization: (a) may not qualify for the exemption; or (b) may not be paying tax on an unrelated business or other taxable activity.

Restrictions on Church Inquiries and Examinations

Restrictions on church inquiries and examinations apply only to churches (including organizations claiming to be churches if such status has not been recognized by the IRS) and conventions or associations of churches. They do not apply to related persons or organizations. Thus, for example, the rules do not apply to schools that, although operated by a church, are organized as separate legal entities. Similarly, the rules do not apply to integrated auxiliaries of a church.

Restrictions on church inquiries and examinations do not apply to all church inquiries by the IRS. The most common exception relates to routine requests for information. For example, IRS requests for information from churches about filing of returns, compliance with income or Social Security and Medicare tax withholding requirements, supplemental information needed to process returns or applications, and other similar inquiries are not covered by the special church audit rules.

Restrictions on church inquiries and examinations do not apply to criminal investigations or to investigations of the tax liability of any person connected with the church, e.g., a contributor or minister.

The procedures of IRC section 7611 will be used in initiating and conducting any inquiry or examination into whether an excess benefit transaction (as that term is used in IRC section 4958) has occurred between a church and an insider.

Audit Process

The following is the sequence of the audit process.

1. If the *reasonable belief* requirement is met, the IRS must begin an inquiry by providing a church with written notice containing an explanation of its concerns.

2. The church is allowed a reasonable period in which to respond by furnishing a written explanation to alleviate IRS concerns.

3. If the church fails to respond within the required time, or if its response is not sufficient to alleviate IRS concerns, the IRS may, generally within 90 days, issue a second notice, informing the church of the need to examine its books and records.

4. After issuance of a second notice, but before commencement of an examination of its books and records, the church may request a conference with an IRS official to discuss IRS concerns. The second notice will contain a copy of all documents collected or prepared by the IRS for use in the examination and subject to disclosure under the Freedom of Information Act, as supplemented by IRC section 6103 relating to disclosure and confidentiality of tax return information.

5. Generally, examination of a church's books and records must be completed within two years from the date of the second notice from the IRS.

If at any time during the inquiry process the church supplies information sufficient to alleviate the concerns of the IRS, the matter will be closed without examination of the church's books and records. There are additional safeguards for the protection of churches under IRC section 7611. For example, the IRS cannot begin a subsequent examination of a church for a five-year period unless the previous examination resulted in a revocation, notice of deficiency or assessment, or a request for a significant change in church operations, including a significant change in accounting practices.

Glossary

Church. Certain characteristics are generally attributed to churches. These attributes of a church have been developed by the IRS and by court decisions. They include: distinct legal existence; recognized creed and form of worship; definite and distinct ecclesiastical government; formal code of doctrine and discipline; distinct religious history; membership not associated with any other church or denomination; organization of ordained ministers; ordained ministers selected after completing prescribed courses of study; literature of its own; established places of worship; regular congregations; regular religious services; Sunday schools for the religious instruction of the young; schools for the preparation of its ministers. The IRS generally uses a combination of these characteristics, together with other facts and circumstances, to determine whether an organization is considered a church for federal tax purposes.

The IRS makes no attempt to evaluate the content of whatever doctrine a particular organization claims is religious, provided the particular beliefs of the organization are truly and sincerely held by those professing them and the practices and rites associated with the organization's belief or creed are not illegal or contrary to clearly defined public policy.

Integrated Auxiliary Of A Church. The term *integrated auxiliary* of a church refers to a class of organizations that are related to a church or convention or association of churches, but are not such organizations themselves. In general, the IRS will treat an organization that meets the following three requirements as an integrated auxiliary of a church. The organization must:

- be described both as an IRC section 501(c)(3) charitable organization and as a public charity under IRC sections 509(a)(1), (2), or (3),
- be affiliated with a church or convention or association of churches, and
- receive financial support primarily from internal church sources as opposed to public or governmental sources.

Men's and women's organizations, seminaries, mission societies, and youth groups that satisfy the first two requirements above are considered integrated auxiliaries whether or not they meet the internal support requirements. More guidance as to the types of organizations the IRS will treat as integrated auxiliaries can be found in the Code of Regulations, 26 CFR section 1.6033-2(h).

The same rules that apply to a church apply to the integrated auxiliary of a church, with the exception of those rules that apply to the audit of a church. See section Special Rules Limiting IRS Authority To Audit A Church on page 26.

Minister. The term *minister* is not used by all faiths; however, in an attempt to make this publication easy to read, we use it because it is generally understood. As used in this booklet, the term minister denotes members of clergy of all religions and denominations and includes priests, rabbis, imams, and similar members of the clergy.

IRC Section 501(c)(3). IRC section 501(c)(3) describes charitable organizations, including churches and religious organizations, which qualify for exemption from federal income tax and generally are eligible to receive tax-deductible contributions. This section provides that:

- an organization must be organized and operated exclusively for religious or other charitable purposes,
- net earnings may not inure to the benefit of any private individual or shareholder,
- no substantial part of its activity may be attempting to influence legislation,
- the organization may not intervene in political campaigns, and
- the organization's purposes and activities may not be illegal or violate fundamental public policy.

These requirements are set forth in greater detail throughout this publication.

Help From The IRS

IRS Tax Publications to Order

The IRS provides free tax publications and forms. Order publications and forms by calling toll-free (800) 829-3676, or download publications and forms from the IRS Web site at www.irs.gov. The following list of publications may provide further information for churches and other religious organizations:

Publication 1	*Your Rights as a Taxpayer*
Publication 15	*Circular E, Employer's Tax Guide*
Publication 15-A	*Employer's Supplemental Tax Guide*
Publication 334	*Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*
Publication 463	*Travel, Entertainment, Gift, and Car Expenses*
Publication 517	*Social Security and Other Information for Members of the Clergy and Religious Workers*
Publication 525	*Taxable and Nontaxable Income*
Publication 526	*Charitable Contributions*
Publication 557	*Tax-Exempt Status for Your Organization*
Publication 561	*Determining the Value of Donated Property*
Publication 571	*Tax-Sheltered Annuity Programs for Employees of Public Schools and Certain Tax-Exempt Organizations*
Publication 598	*Tax on Unrelated Business Income of Exempt Organizations*
Publication 910	*Guide to Free Tax Services*
Publication 1771	*Charitable Contributions: Substantiation and Disclosure*
Publication 3079	*Gaming Publication for Tax-Exempt Organizations*
Publication 4221-PC	*Compliance Guide for 501(c)(3) Public Charities*
Publication 4573	*Group Exemptions*
Publication 4630	*Exempt Organizations Products and Services Navigator*

IRS Customer Service

Telephone assistance for general tax information is available by calling: IRS Customer Service toll-free at (800) 829-1040.

EO Customer Service

Telephone assistance specific to exempt organizations is available by calling: IRS Exempt Organizations Customer Account Services toll-free at (877) 829-5500.

EO Web Site

Visit the IRS Exempt Organizations Web site at www.irs.gov/eo.

Stay Exempt - Tax Basics for 501(c)(3)s - a free on-line IRS workshop covering tax compliance issues confronted by small and mid-sized tax-exempt organizations, available at www.stayexempt.irs.gov.

EO Update

To receive IRS EO Update, a periodic newsletter with information for tax-exempt organizations and tax practitioners who represent them, visit www.irs.gov/eo and click on "EO Newsletter."

Congress has enacted special tax laws applicable to churches, religious organizations, and ministers in recognition of their unique status in American society and of their rights guaranteed by the First Amendment of the Constitution of the United States. Churches and religious organizations are generally exempt from income tax and receive other favorable treatment under the tax law; however, certain income of a church or religious organization may be subject to tax, such as income from an unrelated business. It is also important for a church or religious organization to understand the tax law to avoid losing its tax-exempt status by engaging in activity that violates the Internal Revenue Code.

Publication 1828 (11-2009) Catalog Number 21096G Department of the Treasury **Internal Revenue Service** www.irs.gov