



Exempt Organizations Technical Guide

TG 3-10: Disqualifying and Non-Exempt Activities - Trade or Business Activities – IRC Section 501(c)(3)

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I. Overview

- (1) This Technical Guide (TG) addresses the issue of Section 501(c)(3) organizations engaging in trade or business activities and how this affects an organization's tax-exempt status.

A. Background / History

- (1) Prior to 1950, exempt organizations enjoyed total exemption from Federal income tax. If a charitable organization met the organizational and operational requirements of the statute, there was no limitation on the amount of business activity an exempt organization could conduct if the earnings from the business were used for exempt purposes. Concerns included:
 - a. The Courts extended the "destination of income test" to charitable organizations whose primary purpose was to carry on a trade or business for profit and turn over such profits to one or more exempt organizations.
 - b. Charitable organizations were acquiring real estate with borrowed funds. A typical transaction involved a tax-exempt organization borrowing money to acquire real estate, leasing the property back to the seller under a long-term lease, and servicing the loan with tax-free rental income from the lease.
- (2) The Revenue Act of 1950 imposed a tax on the unrelated business income of charitable organizations (not including churches) and certain other exempt organizations. The primary purpose was to prevent unfair competition.
- (3) The Tax Reform Act of 1969 made significant changes to the unrelated business income tax rules by:
 - a. Extending the tax to all exempt organizations described in Section 501(c) and 401(a) (except United States instrumentalities)
 - b. Expanding the tax on debt-financed income to cover not only certain rents from debt-financed acquisitions of real estate, but to tax other debt-financed income
 - c. Subjecting some payments to a tax-exempt organization of interest, annuities, royalties, and rent from a taxable or tax-exempt subsidiary of such organization to tax.
- (4) Since 1969, Congress has made a number of changes to the unrelated business income tax rules, but the structure of the tax has remained largely intact. Mostly, changes have been to provide additional income exclusions from tax on certain activities, including:
 - a. Rules relating to payments from taxable and tax-exempt subsidiaries to an exempt parent were tightened to prevent subsidiaries of tax-exempt organizations from reducing their otherwise taxable income by borrowing leasing, or licensing assets from a tax-exempt parent organization at inflated levels (1997)

- b. Providing an exclusion from the definition of acquisition indebtedness (certain indebtedness of a small business investment company licensed under the Small Business Investment Act of 1958)
 - c. Providing an exclusion for the gain or loss from certain dispositions of certain brownfield property (American Jobs Creation Act of 2004).
- (5) The Tax Cuts and Jobs Act of 2017 specified tax-exempt organizations must compute unrelated business taxable income, including any net operating loss (NOL) deductions, separately for each trade or business (referred to as a "silo") for tax years beginning after 12/31/2017.

B. Relevant Terms

- (1) **Trade or Business:** Any activity carried on for the production of income via the sale of goods or performance of services.
- (2) **Unrelated Trade or Business:** Any trade or business, the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501.

C. Law / Authority

- (1) Section 501(c)(3)
- (2) Section 502
- (3) Section 511
- (4) Section 512
- (5) Section 513
- (6) Treasury Regulation (Treas. Reg.) 1.501(c)(3)-1
- (7) Treas. Reg. 1.513

II. Section 501(c)(3) Organizations

- (1) In general, the following requirements exist for an organization to receive tax-exempt status under Section 501(c)(3):
 - a. Organized and operated exclusively for exempt purposes
 - b. No private inurement to organization insiders
 - c. No more than an incidental private benefit to private persons who aren't organization insiders
 - d. No substantial part of the organization's activities may be lobbying
 - e. The organization may not participate or intervene in political activities.
- (2) An exempt organization may have revenue from four sources:
 - a. Contributions, gifts, and grants

- b. Trade or business income that is related to exempt activities (program service revenue)
 - c. Investment income
 - d. Trade or business income that isn't related to exempt activities
- (3) In general, the Federal income tax exemption extends to the first three categories and doesn't extend to an organization's unrelated trade or business income.
 - (4) Activities related to a Section 501(c)(3)'s exempt purpose won't have an adverse effect on receiving or maintaining its tax-exempt status. However, activities not substantially related to an exempt purpose of the organization could have an adverse tax effect and possibly bar an organization from receiving exemption or jeopardize its continued exempt status.

A. Organizational and Operational Tests

- (1) Section 501(c)(3) requires an organization to be both "organized" and "operated" exclusively for one or more Section 501(c)(3) purposes. If the organization fails either the organizational test or the operational test, it isn't exempt. See Treas. Reg. 1.501(c)(3)-1(a)(1).
- (2) The organizational test applies to the organization's articles of organization (also known as the "organizing document").
- (3) The term "exempt purpose" means any purpose or purposes specified in section 501(c)(3) – charitable, religious, scientific, testing for public safety, literary, educational, fostering national or international sports competitions, or the prevention of cruelty to children or animals.
- (4) In applying the operational test, the IRS focuses on the organization's operations through its activities and how those activities further exempt purposes.
- (5) See Exempt Organizations Technical Guide, TG 3-1: IRC 501(c)(3) Overview, Application, Exemption Requirements for organizational and operational requirements.

B. Unrelated Trade or Business

- (1) The organization's use of the profits from an activity doesn't make the activity substantially related to an organization's exempt purpose or function. Rather, this determination is activity based.
- (2) Section 513(a) defines the term "unrelated trade or business" as any trade or business, the conduct of which isn't substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501 (or, in the case of an organization described in Section

511(a)(2)(B), to the exercise or performance of any purpose or function described in Section 501(c)(3)).

- (3) A Section 501(c)(3) organization is engaged in unrelated trade or business if the activity is:
 - a. A trade or business
 - b. Regularly carried on
 - c. Not substantially related to the organization's exempt purpose
- (4) The following code sections apply to unrelated trade or business activity of exempt organizations:
 - a. Section 511, Imposition of tax on unrelated business income of charitable, etc., organizations
 - b. Section 512, Unrelated business taxable income
 - c. Section 513, Unrelated trade or business
 - d. Section 514, Unrelated debt-financed income
- (5) Section 502, Feeder organizations, provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt because all of its profits are payable to an exempt organization. See Section III. C. Feeder Organizations, following.

B.1. Excluded Activities

- (1) Exceptions from unrelated trade or business activity include the following situations:
 - a. Substantially all the work is performed by volunteers.
 - b. Activity is carried on for an organization described in Section 501(c)(3) or a college or university primarily for the convenience of its members, students, patients, officers, or employees.
 - c. Substantially all of the merchandise sold was donated.

See Section 513(a) and Treas. Reg. 1.513-1(e).

- (2) Regarding volunteer labor:
 - a. **Volunteers** are defined as people who aren't compensated for their work. Mere reimbursement of expenses incurred by volunteers is not compensation.
 - b. The term "**substantially all**" isn't defined in Section 513 or the regulations. When analyzing all the facts and circumstances, it's helpful to identify and compare the number of hours worked by those uncompensated to the number of hours worked by those compensated to determine if substantially all the work is carried on by unpaid volunteers. The type of work performed by those who are compensated versus

volunteer labor should also be considered. Existing court cases don't apply a set percentage test. The "substantially all" test is to be applied in a general manner.

- c. Work provided by **third-party contractors** isn't volunteer labor. If the organization conducting trade or business activities makes a payment to a third party in return for supplying labor, the amount paid is considered compensation in applying the volunteer labor exception. It's irrelevant that workers aren't compensated directly by the organization. What is relevant is that compensation is paid for the labor, not whether or not the labor is paid as employees or independent contractors.
- d. A **significant factor** is whether the services performed by volunteers is material in the income-producing endeavor. In Rev. Rul. 78-144, the IRS reasoned that although the work in carrying on the activity may be volunteer labor, the performance of service was not a material income-producing factor in carrying on the business. Therefore, the volunteer exception didn't apply to the activity.

(3) Compensation is interpreted broadly and can take many forms.

- a. **Tips** received by workers are compensation even though they are not paid by the organization.
- b. A worker who obtains goods or services at a **reduced price** in return for his services may be considered compensated.
- c. At the same time, there must be a "**but-for**" connection between the payment and the services, such that the payment would not otherwise be received but for the provision of services.

De minimis amounts received by workers aren't compensation.

Reimbursement of incurred expenses is not compensation. Free food and beverages may be considered payment of compensation. However, the facts and circumstances of each case must be examined to determine if the amounts in question are de minimis.

Workforce constitutes all workers involved in carrying out the activities in question must be considered. This could include any workers involved in the activity.

- (4) Trade or business activity will meet the **convenience exception** if it is carried on by the organization primarily for the convenience of its members, students, patients, officers, or employees.
- (5) The sale of donated merchandise substantially all of which has been received as a gift or contribution is generally not an unrelated trade or business.
- (6) The following court cases and rulings address exceptions to trade or business activities:

- a. *Waco Lodge No. 166, Benevolent and Protective Order of Elks v. Commissioner*, 696 F.2d. 372 (5th Cir. 1983). The organization, granted exemption pursuant to Section 501(c)(3), conducted profit-making bingo games with work performed for cash compensation, and the balance of the work performed by volunteers. Four of the volunteers received free drinks from the bar where the main part of the bar's business on those nights came from the people playing bingo. The Tax Court "determined that Section 513(f), the so-called 'bingo exception,' did not exempt the Lodge from taxation, because the bingo games were illegal under Texas law. The Lodge did not challenge that determination." The court held that the availability and value of the free drinks, averaging 63 cents per hour, was not compensation because the court did "not believe that the Code's definition of compensation was meant to include such a trifling inducement." Additionally, it determined a substantial percentage, approximately 21 %, of the work performed was compensated and prevented the bingo operation from meeting the exception for volunteer labor under Section 513(a)(1).
- b. *St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner*, 85 T.C. 9 (1985), non-acq. 1986-2 C.B. 1. A Section 501(c)(3) religious order, a subordinate of the US Catholic Conference which was granted a group exemption, operated a farm which produced livestock and crops that were marketed commercially. The religious order participated in federal farm subsidy programs and received subsidies over \$10,000 in two of the years examined. The religious order was comprised of Brothers who took a vow of poverty and received no actual compensation in the form of salaries. All Brothers residing on the farm received food, clothing, shelter, and medical care, regardless of whether they were involved in farm operations. The Tax Court held that although the organization's farming operations constituted unrelated trade or business, the exception for volunteer labor under Section 513(a)(1) was applicable. The court pointed to 94 percent of the total hours worked in operating the farm and 91 percent of the labor is supplied by the Brothers. The court reasoned that the support provided the Brothers operating the farm wasn't compensation for purposes of Section 513(a)(1), since such support would be provided to each Brother regardless of whether the Brother was assigned to operating the farm.
- c. *Shiloh Youth Revival Centers, Inc. v. Commissioner*, 88 T.C. 565 (1987). The members of a Section 501(c)(3) religious organization engaged in forestry, cleaning and maintenance, painting, and other "donated labor" activities. The organization claimed the conduct of its trades or business was substantially related to its tax-exempt purpose, but the court concluded that the exempt functions of its activities were incidental to raising revenue. The members accepted virtually all types of unskilled jobs with the organization's primary concern being production of income and maintaining full employment. Also, its formal work philosophy was

developed to strengthen its defense against imposition of unrelated business income tax and desire to reduce its tax burden. The court concluded that the conduct of the organization's business was not substantially related to its purposes of religious training, worship, and evangelism. However, unlike the ruling in *St. Joseph Farms*, the court stated the activities were not peculiarly suited to the accomplishment of its objectives and the volunteer labor exception under Section 513(a)(1) didn't apply because the organization's members didn't receive benefits if they didn't display at least a willingness to work and the organization would not have tolerated members who refused to work. Moreover, the organization could provide for the needs of its members only if virtually all the members work as compared with *St. Joseph's Farms* where only 12 to 14 out of the 167 members worked in *St. Joseph's* unrelated business. In *St. Joseph's*, if farm operations ceased the Brothers who operated the farm would receive the same support whereas here if business operations ceased it would cease to exist. The court concluded that the organization's activities constituted unrelated trade or business.

- d. Rev. Rul. 69-267, 1969-1 C.B. 160. A gift shop operated by a full-time, salaried manager assisted by members of the hospital auxiliary of a hospital exempt under Section 501(c)(3) that results in an annual net profit which is made part of the hospital's general operating fund is for the convenience of its patients, visitors and employees and isn't an unrelated trade or business activity.
- e. Rev. Rul. 74-399, 1974-2 C.B. 172. The operation of a dining room, cafeteria, and snack bar not contemplated or designed to serve as a public restaurant but merely to serve the exempt purposes of the exempt art museum for the convenience of its staff, employees and members of the public visiting the museum is substantially related to the museum's exempt purposes and consequently doesn't constitute an unrelated trade or business activity.

B.2. Special Exceptions

- (1) Over the years, tax-exempt organizations have successfully lobbied Congress for special exceptions to unrelated trade or business. The exceptions are limited to specific types of exempt organizations for specific events or activities.
- (2) Exceptions include:
 - a. **Section 513(d)** Qualified convention and trade show activities carried on by qualifying organizations described in Sections 501(c)(3), (4), (5), and (6). See *Treas. Reg. 1.513-3*.

Income from a qualified public entertainment activity engaged in by qualified organizations described in Sections 501(c)(3), (4), (5). A qualified public entertainment activity is one traditionally conducted at fairs or expositions promoting agricultural and educational purposes, including,

but not limited to, any activity one of the purposes of which is to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment See Section 513(d)(2)(B).

- b. **Section 513(e)** Tax-exempt hospital or a cooperative organization created by two or more tax-exempt hospitals providing specific services to other hospitals that have facilities to serve not more than 100 inpatients. See Treas. Reg. 1.513-6.
- c. **Section 513(f)** Unrelated trade or business does not include any trade or business which consists of conducting certain bingo games. See Section 513(f) and Treas. Reg. 1.513-5.
- d. **Section 513(h)** Distribution of low-cost articles without obligation to purchase and exchanges and rentals of member lists. Certain distributions of “low-cost articles,” if the distribution is incidental to the solicitation of charitable contribution, and a trade or businesses involved with exchanges and rentals of member lists aren’t an unrelated trade or business. See Section 513(h).
- e. **Section 513(i)** Soliciting and receiving “qualified sponsorship payments” is not an unrelated trade or business. There are several requirements and limitations to be a “qualified sponsorship payment.” See Section 513(i) and Treas. Reg. 1.513-4.

B.3. Profit Motive

- (1) Taxable corporate entities are organized to conduct activities for a profit. Absent specific compelling evidence to the contrary, taxable corporate activities, even if they suffer several years of net losses, are presumed to be conducted for a profit motive.
- (2) An activity must be profit-motivated in order to be considered a “trade or business” for purposes of Section 513.
- (3) In *United States v. American Bar Endowment*, 477 U.S. 105, 106 S. Ct. 2426 (1986), the court held that a Section 501(c)(3) organization's insurance program operated like a commercial entity and was a trade or business for purposes of tax on unrelated business income. American Bar Endowment (ABE) engaged in the following activity:
 - a. Served as group policyholder and administrator of insurance policies offering life, accident, disability, and medical coverage.
 - b. Negotiated premium rates with insurers and selected which insurer would provide coverage.
 - c. Compiled a list of its members, solicited their insurance business, collected premiums, transmitted premiums to the insurer, maintained files on each policyholder, answered member's questions concerning insurance policies, and screened claims for benefits.

- d. Received all dividends (as required by member agreement) to further its charitable and educational activities.

The Court stated that assembling a group of better than average insurance risks, negotiating on their behalf with insurance companies, and administering a group policy are activities engaged in by private commercial entities to make a profit. The Court rejected ABE's arguments that its insurance activities weren't a trade or business, citing the crucial fact that members were required to assign to ABE all dividends as a condition of participating in the insurance program. The Court stated it's simply incorrect to characterize the assignment of dividends by each member as voluntary.

The Court held that the "standard test for the existence of a trade or business for purposes of [Section] 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.' Thus, several Courts of Appeals have adopted the 'profit motive' test to determine whether an activity constitutes a trade or business for purposes of the unrelated business income tax." (citations omitted).

- (4) Cases involving the issue of whether an activity is a trade or business are "fact specific". A decision is reached based on the facts in the case rather than a point of law. In ABE, the Court determined that ABE conducted the activity like a for-profit insurance broker. More so, ABE was as a standard example of monopoly pricing, provided group insurance coverage with the characteristics of a natural monopoly, and chose to appropriate for itself all of the profit possible from that asset. Also, ABE received dividends normally accruing to its members as compensation for performing the insurance activity.
- (5) The Court stated that pre-existing groups like the ABA or a trade association obviously have a considerable advantage over new entrants. The Court concluded ABE's insurance program presented the potential for unfair competition, there was no danger of unfair competition, and was an example of precisely the sort of unfair competition Congress intended to prevent with UBIT. The facts of the case supported the conclusion that ABE was conducting a trade or business with a profit motive.

B.4. Regularly Carried On

- (1) Trade or business activities must be "regularly carried on." Business activities of an exempt organization will ordinarily be considered "regularly carried on" if they're conducted with a frequency and continuity, and are pursued in a manner, similar to comparable commercial activities of nonexempt organizations. See Treas. Reg. 1.513-1(c)(1).
- (2) Treas. Reg. 1.513-1(c)(2) provides the application of the rules:

Subsection (i) states:

- a. Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a **year-round basis**, the conduct

of such activities by an exempt organization **over a period of only a few weeks** does not constitute the regular carrying on of trade or business.

For example, the operation of a sandwich stand, by a hospital auxiliary for only two weeks at a state fair would not be the regular conduct of trade or business. But the conduct of year-round business activities **for one day each week** would constitute the regular carrying on of trade or business.

- b. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a **seasonal basis**, the conduct of such activities by an exempt organization during a **significant portion of the season** ordinarily constitutes the regular conduct of trade or business.

Subsection (ii) states:

- a. In determining whether or not **intermittently conducted** activities are regularly carried on, how the activities are conducted must be compared with the **manner in which commercial activities are normally pursued** by nonexempt organizations.
- b. In general, activities which are engaged in only **discontinuously or periodically** won't be considered regularly carried on if they're conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances won't ordinarily be deemed to be the regular carrying on of business.

Subsection (iii) states:

- a. Certain **intermittent** income producing activities occur so infrequently that neither their recurrence nor how they may be otherwise conducted will cause them to be regarded as regularly carried on.
- b. Activities lasting only a **short period of time** won't ordinarily be treated as regularly carried on if they recur only occasionally or sporadically.
- c. Such activities won't be regarded as regularly carried on merely because they are conducted on an **annually recurrent basis**. For example, income from the conduct of an annual dance or similar fundraising event for charity wouldn't be income from trade or business regularly carried on.

(3) The following revenue rulings and court cases address the "regularly carried on" requirement:

- a. Rev. Rul. 68-505, 1968-2 C.B. 248, holds that a two-week horse racing meet featuring pari-mutuel betting conducted by a Section 501(c)(3) county fair association is regularly carried on because it is usual to carry on such trade or business only during a particular season.
- b. Rev. Rul. 73-424, 1973-2 C.B. 190, holds that the sale of advertising by a Section 501(c)(5) organization in its annual yearbook was a "regularly

carried on" activity. Although the publication was distributed only on an annual basis, the advertising solicitation required that a significant span of time be devoted to the activity. The ruling states the organization was engaged in activity typical of commercial endeavors and the activity occurred with a frequency and continuity similar to commercial activities.

- c. Rev. Rul. 75-200, 1975-1 C.B. 163, holds that the sale of advertising for a concert program, by employees of a Section 501(c)(3) organization, which it publishes weekly to distribute free over an eight-month period is a business "regularly carried on." The majority of the advertisements are sold in a general solicitation campaign extending over a four-month period, where the rates charged for the advertising are generally competitive with commercial publications. The ruling states the advertising activity didn't differ substantially from comparable commercial activities of nonexempt organizations.
- d. Rev. Rul. 75-201, 1975-1 C.B. 164, holds that the sale by a Section 501(c)(3) organization of commercial advertisements for concert books that it publishes and distributes at its annual charity ball to raise funds for a Section 501(c)(3) symphony orchestra is not "regularly carried on." A major purpose of the organization was to raise funds for the symphony orchestra. The revenue ruling states that the advertising income is not "regularly carried on" within the meaning of Treas. Reg. 1.513-1(c)(2)(iii) because the distribution of the concert books is part of an annual charity ball, advertising solicitation is largely carried on by the volunteer committee and is an intermittent activity that does not continue for an extended period.
- e. In *Suffolk County Patrolmen's Benevolent Association, Inc. v. Commissioner*, 77 T.C. 1314 (1981), acq. 1984-2 C.B. 2, the court determined that a fundraising activity conducted, based on the facts and circumstances in the case, one weekend per year over a six-year period was an intermittent activity. Also, preparation for the shows, including the solicitation of advertisers, lasted no longer than 8 to 16 weeks per year. The court stated that activities engaged in only discontinuously or periodically generally won't be considered regularly carried on if conducted without the competitive and promotional efforts typical of commercial endeavors. The conclusions that can be drawn from this case are:
 - 1) The time span for measuring the conduct of a fundraising activity is the preparation and conduct of the event itself. If it's infrequent (8-12 weeks prep and the event only one weekend per year), it's intermittent.
 - 2) If the activity is an intermittent fundraising activity, the manner in which it's conducted isn't determinative in whether it's regularly carried on.

- 3) The fact that the organization hired professionals to conduct the event and do most of the preparatory work didn't change the activity from intermittent to regularly carried on.
- f. In *National Collegiate Athletic Association v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990), which reversed *National Collegiate Athletic Association v. Commissioner*, 92 T.C. 456 (1989), the NCAA conceded that its program advertising was a "trade or business" not "substantially related" to its exempt purpose. However, the Appellate Court determined that the sale of advertising space in programs sold at "The Final Four" Basketball Tournament wasn't "regularly carried on." The court stated that to determine the normal time span of the activity it considered the business of selling advertising space as that's the business that'd be generating unrelated business taxable income because the tournament itself is substantially related to the NCAA's exempt purpose and isn't the business activity in question. Even though the preparation and solicitation of the advertising by a third-party publisher took place over a period of several months, the court determined that the time span to be used was that of the event that earned the advertising income. Therefore, in this case, the time span to be used in measuring the conduct of the activity was the actual length of the tournament which was less than 3 weeks. The Court stated that the publication of advertising is generally conducted on a year-round basis. However, the NCAA's sale of program advertising was conducted for only a few weeks and that time-period standing alone couldn't convert the NCAA's business into one regularly carried on. The court considered the 3-week event "infrequent" and therefore intermittent. The court stated it is not necessary to prove or disprove the existence of actual competition but determined that the NCAA's once-a-year program shouldn't be considered an unfair competitor for the publishers of advertising.

IRS Action on Decision - The IRS disagreed with the factual characterizations and legal conclusions of the court in A.O.D. 1991-15, 1990 WL 692279. The IRS maintained the tournament was seasonal, like other sports tournaments, not intermittent. Additionally, the NCAA's advertising activity is indistinguishable from that of many commercial businesses. While the court, ignoring Treas. Reg. 1.513-1(b), concluded that the time span of the activity should be limited to the duration of the actual event, the IRS position is that it should include the several months of planning and preparation for the event.

The conclusions that can be drawn from this case are as follows:

- 1) Attributing the actions of a hired professional to the exempt organization in order to determine the time span of an activity was not accepted by the court.

- 2) The court concluded the actual time span or length of an event or activity is used in measuring the conduct of the activity.
- 3) Comparison of the conduct of the organization's activity to a similar activity of a nonexempt entity did not support the concept that the activity was an intermittent activity or was regularly carried on.

C. Exempt Purpose(s)

- (1) An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it:
 - a. Engages primarily in activities which accomplish one or more of the exempt purposes specified in Section 501(c)(3).
 - b. No more than an insubstantial part of its activities don't further exempt purposes. See Treas. Reg. 1.501(c)(3)-1(c)(1).
- (2) The purposes specified in Section 501(c)(3) are:
 - a. Religious
 - b. Charitable
 - c. Scientific
 - d. Testing for public safety
 - e. Literary
 - f. Educational
 - g. Fostering national or international sports competition
 - h. Prevention of cruelty to children or animals.
- (3) The terms "exclusively," "primarily," "substantial" and "insubstantial" for purposes of the operational test, apply to the review of the purposes, activities, time, and resources of exempt organizations to determine if they are operating for Section 501(c)(3) purposes. There is no express formula or measurement in the Internal Revenue Code for the operational test. Rather, all facts and circumstances pertaining to the operational test should be considered when making these determinations. Often, exemption is determined on the basis of stated purposes and proposed activities.
- (4) An organization isn't operated exclusively for exempt purposes under Section 501(c)(3) if it has a single non-exempt purpose that is substantial in nature, regardless of the number or importance of the organization's exempt purposes.
- (5) However, an organization may still meet the requirements although it operates a trade or business as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purpose(s) and if the organization isn't organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in Section 513. See Treas. Reg. 1.501(c)(3)-1(e).

- (6) Whether an organization meets the requirements of Section 501(c)(3) even though it operates a trade or business depends on "the purposes toward which an organization's activities are directed, and not the nature of the activities."
- (7) In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered. Factors to be considered include the size and extent of the trade or business and the size and extent of the activities which further the exempt purposes.
- (8) An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business isn't exempt under Section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits don't inure to the benefit of individual members of the organization. See Section 501(d) and Treas. Reg. 1.501(d)-1 relating to religious and apostolic organizations.
- (9) The following court cases address the primary purpose issue:
 - a. *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978). The court ruled the organization, organized to provide consulting services for a fee to tax-exempt and non-profit clients, didn't qualify for exemption under Section 501(c)(3) because it didn't operate for exempt purposes but had a primary purpose that was commercial. Its activity constituted the conduct of a consulting business of the sort which is ordinarily carried on by commercial ventures organized for profit.
 - b. *Dumaine Farms v. Commissioner*, 73 T.C. 650 (1980). A trust operating a model farm as a demonstration conservation project applied for exempt status under Section 501(c)(3) as a scientific and educational organization. When it first applied it had engaged in no operations and it was not fully operational by its final submission to the administrative record. The IRS denied the application. The court stated the issue was a standard question of whether this was a commercial enterprise or whether it meets the organizational and operational tests and is exempt under Section 501(c)(3). The court noted that the organization's operation of a conservation project, experimental projects and demonstration function furthered its purpose of conserving the ecology. The articles appropriately limited its purposes including that it shall not be the purpose of the trust to make money except incidentally to its exempt purpose. Additionally, the court stated the organization's goal was "to test and demonstrate the restoration of overcultivated, exhausted land to a working ecological balance" and that for "this reason it [was] essential to the [organization's] purpose that the land be generally representative of the surrounding farmland." The fact the land didn't have any significant environmental attributes or part of an ecologically significant undeveloped area wasn't a bar to exemption.

Although the organization would not plant cash crops, it will plant and harvest on a commercial scale. Additionally, the farm was not open

continuously to the public like a museum or nature trails, but the organization worked closely with public agencies and academic institutions to develop additional research. The Department of Agriculture previously and currently worked to help conserve the land and the State wanted to engage in conservation on the organization's land. The organization intended to participate in a State conservation program. Research and results would be shared with county farmers and the public.

Note: See A.O.D. 1980-45 and subsequent IRS Announcement relating to: Dumaine Farms, 1980-2 C.B. 1(1980) indicating IRS acquiescence on the issues relating to (1) whether petitioner was operated exclusively in furtherance of exempt purposes, and (2) whether petitioner served private rather than public interests. The IRS non-acquiescence on the issue relating to whether petitioner was organized exclusively for exempt purposes and that if an organization's purposes are more specific than those listed in Section 501(c)(3) then, pursuant to Treas. Reg. 1.501-(c)(3)(b)(1)(ii), it must describe the manner of its operations in detail.

C.1. Fragmentation Rule

(1) While tax-exempt organizations are organized for exempt purposes, they may conduct both exempt activities and activities that are considered a trade or business.

(2) The fragmentation rule found in Section 513(c) states in part:

For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity doesn't lose identity as a trade or business merely because it's carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purpose of the organization.

(3) The fragmentation rule allows each trade or business activity to be analyzed separately even though the conduct of the activity may be entwined with the conduct of exempt activities or other trade or business activities.

(4) To illustrate the fragmentation rule, the following example is provided:

Facts - A rural hospital described in Section 501(c)(3) operates a kitchen facility to provide meals to its inpatients at below cost. In addition, the hospital also delivered meals to elderly shut-ins and to a social club on a fee basis. The meals provided to the elderly are provided at slightly more than the hospital's cost but substantially less than what the same meal would cost the elderly from a for-profit caterer. The meals delivered to the social club result in a significant net profit.

Analysis - The hospital is conducting the following three activities:

a. Sale of meals to inpatients at less than cost

- b. Sale of meals to elderly shut-ins at more than cost but less than fair market value (the amount a taxable entity would charge)
- c. Sale of meals to a social club at a net profit

All three activities are conducted within the framework of one hospital activity and the one kitchen facility with, primarily, the same personnel.

Conclusion - The activities are conducted for different economic purposes as follows:

- a. The first activity isn't profit-motivated, so it's not a trade or business. The activity serves the exempt charitable purpose of the hospital.
- b. The second activity is a trade or business because it's profit motivated. This activity provides food to elderly shut-ins at a profit.
- c. The third activity is a trade or business because it's profit motivated. The activity provides food to the social club at a profit.

By using the provisions of Section 513(c) to fragment the kitchen activity, the organization ends up with three activities, two of which are trade or business activities.

C.2. Substantially Related

- (1) Even though an activity qualifies as a trade or business, it still may not be an "unrelated trade or business" activity. Trade or business activity is unrelated if it isn't substantially related to the achievement of the organization's exempt purpose.
- (2) A business activity isn't substantially related to an organization's exempt purpose if it doesn't contribute importantly to accomplishing that purpose (other than through the production of income).
- (3) The term "substantially related" requires an examination of how a business activity that generates the income helps an organization accomplish its exempt purpose. Treas. Reg. 1.513-1(d) states that to be substantially related:
 - a. The conduct of the business activity must have a "causal relationship" to the achievement of exempt purposes. And the "causal relationship" must be substantial.
 - b. The conduct of the business activity must "contribute importantly" to the accomplishment of the organization's exempt purposes to be substantially related.
- (4) To "contribute importantly" depends on the facts and circumstances of each case. You'll need to consider how the size and the extent of the activities relate to the nature and extent of the exempt function they intend to serve.
- (5) In *United States v. American College of Physicians*, 475 U.S. 834 (1986), the U.S. Supreme Court provided guidelines for determining when an activity was substantially related to an organization's exempt purpose activities.

Facts:

- a. The American College of Physicians (ACP) is an organization recognized as exempt under Section 501(c)(3).
- b. ACP's purposes included upholding and maintaining high standards in medical education and medical practice encouraging medical research (especially in clinical medicine); and fostering measures for the prevention of disease and for the improvement of public health.
- c. In furtherance of its exempt purpose, ACP published a journal which contained scholarly articles relevant to the practice of internal medicine. It also contained advertisements for pharmaceuticals, of medical products, supplies, and equipment useful in the practice of internal medicine, and notices of positions desired or available in connection with the practice of internal medicine.
- d. Advertisements in the journal were "clustered" in two sections – "one at the front and one at the back of each issue."
- e. Some advertising was for established drugs or devices and was repeated monthly.
- f. The organization's longstanding policy was to accept only advertisements "containing information about the use of medical products. Advertisements were screened for accuracy and relevance to internal medicine.

Court's Analysis:

- a. Scrutiny should be placed on the conduct of the organization rather than the educational quality of the advertisements.
- b. All advertisements contain some information, and if a small amount of informative content were enough to supply the important contribution necessary to achieve tax-exemption for commercial advertising, it would be rare that an advertisement would fail to meet the test. (Even if not creating a per se rule against tax-exemption, is clearly antagonistic to the concept of a per se rule for exemption for advertising revenue.)
- c. The statute directs the focus to the "manner" in which the tax-exempt organization operates its business.

Court's Conclusion:

- a. The Court concluded that the type and subject nature of the ads did not contribute importantly to the organization's educational exempt purpose.
- (6) If an activity serves a substantial nonexempt purpose, however, the organization doesn't qualify for exemption even if the activity also furthers an exempt purpose.
 - (7) In *Schoger Foundation v. Commissioner*, 76 T.C. 380 (1981), a not-for-profit corporation was organized to own and operate a mountain lodge as a religious retreat facility. Only the operational test was at issue. The lodge made available

to its guests numerous activities (religious, recreational, and social) none of which were regularly scheduled or required. The religious activities revolved around individual prayer and contemplation, with optional daily devotions and occasional Sunday services. The recreational and social activities were of the type usually offered at vacation resorts. No records were kept showing the extent of participation by guests in any of the activities. The lodge's brochure references religion but stresses the accommodations and recreational activities. Donations are solicited by cards left in the accommodations listing the expense of lodging and food per day. The court stated the cards are geared towards the organization receiving enough to cover its expenses. The court found the record did not establish that the majority of guest's time was not engaged in recreation, relaxation, and socializing. The court found nowhere in the record was it shown that the recreational facilities were not used in more than an insubstantial manner. The court held that on the facts of the case the organization failed to establish that it was operated primarily for an exempt purpose within the meaning of Section 501(c)(3) and that the recreational and social activities were only incidental and less than substantial.

- (8) The following contrasting revenue rulings illustrate the issue of furthering exempt purposes:
- a. In Rev. Rul. 73-128, 1973-1 C.B. 222, an organization that otherwise qualifies for exemption under Section 501(c)(3) formed to operate a vocational job training program for nonskilled persons unable to find employment or cannot advance from poorly paid employment because of inadequate education was found to further exempt purposes.
 - i. The program involved the manufacture and sale of a line of toy products.
 - ii. Most of the merchandise produced is sold through regular commercial channels.
 - iii. Income from manufacturing finances the organization's other community service activities and deficits are met by public contributions.
 - iv. The organization recruits residents of a particular economically depressed community.
 - v. The program provided the unskilled persons with new skills through on-the-job training while they were earning a living.
 - vi. Trainees hired by the organization weren't hired as permanent employees and the organization tried to place them in permanent positions in the community as soon as they were trained and then recruited new trainees to continue the training process.

The IRS stated manufacture and sale of commercial items as an end itself is not a charitable purpose. However, providing vocational training and guidance to the unskilled and under-employed may qualify as a charitable purpose if the manner of its achievement is otherwise charitable. The question was whether the manufacturing of merchandise was the end or

the means to accomplish a charitable purpose. The IRS concluded it was the means and that there was a clear and distinct causal relationship between the manufacturing and training to improve individuals' abilities. The IRS noted that there was no evidence that the scale of the operation was conducted on a larger scale than was reasonably necessary to accomplish the organization's charitable purpose. The IRS stated the manufacturing activities were an integral part of the training process and an integral part of the organization's charitable program which carried on a business in furtherance of its exempt purposes.

- b. In Rev. Rul. 73-127, 1973-1 C.B. 221, an organization formed to operate a retail grocery store to provide free grocery delivery service to residents who need it, to participate in the Federal food stamp program, and provide job training for unemployed residents was denied exemption. The grocery store planned to sell food to residents of a poverty area at prices substantially lower than those charged by competing grocery stores.
 - i. The store's gross earnings were used principally to pay salaries and to expand the operations of the store.
 - ii. Only about four percent of the store's earnings were allocated for use in a continuous training program for the hard-core unemployed.
 - iii. Some of the trainees became permanent employees at the grocery store.

The IRS denied exemption under Section 501(c)(3) since the operation of the grocery store is in itself an independent objective of the organization and it didn't serve solely as a vehicle for carrying out the training program and was conducted on a scale larger than was reasonably necessary for the performance of the training program.

C.3. Commerciality Doctrine

- (1) While operating a commercial business doesn't automatically cause an organization to fail the operational test, any exempt organization that carries on substantial commercial activities, unrelated to its exempt purposes, will fail the operational test. See Treas. Reg. Section 1.501(c)(3)-1(e)(1).
- (2) Over the years, courts have decided what defines "commercial activity that isn't in furtherance of exempt purposes."
 - a. In *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279 (1945), the court ruled the organization failed to operate for educational purposes because it had a substantial commercial purpose. The organization engaged in activities promoting and protecting the welfare and business methods of merchants to profitably conduct their businesses. The Court noted the commercial nature of the organization's operations as the basis for its conclusion.
- (3) The IRS and the courts have applied the operational test to an organization's activities by comparing the exempt organization's activities to similar activities

carried out by for-profit entities. It is reasoned that an organization operating in a commercial manner has commercial activity as its primary purpose. As the primary purpose, the commercial activities are substantial and unrelated to an organization's exempt purposes, thereby excluding the organization from exemption. This is often referred to as the "commerciality doctrine."

- (4) The courts have also developed factors to consider in analyzing the trade or business activities of tax-exempt organizations.
 - a. In *Living Faith, Inc. v. Commissioner*, 950 F.2d 365 (7th Cir. 1991), the organization was established for the purpose of keeping with the doctrines of the Seventh-day Adventist Church. The court determined the organization didn't qualify for exemption under Section 501(c)(3) by operating as a business in direct competition with restaurants and stores. The court considered the following factors in determining commerciality:
 - i. The organization sold goods and services to the public
 - ii. The organization was in direct competition with for profit businesses
 - iii. The organization operated its businesses under the name of a worldwide chain of restaurants and food stores
 - iv. The prices set by the organization were based on pricing formulas common in retail food businesses and were at or higher than market rates (e.g., buffet prices were three times wholesale cost of food)
 - v. The organization advertised its services and food
 - b. In *Airlie Foundation v. Commissioner*, 283 F. Supp. 2d 58 (D.D.C. 2003), the organization's primary activity was operating a conference center. It organized, hosted, conducted, and sponsored educational conferences in its facilities. It hosts about 600 groups per year and derives 85% of its operating revenue from fees paid by these clients. The IRS revoked its recognition of the organizations tax-exempt status under Section 501(c). The court upheld the IRS denial of the organization's new application for exemption although it carried out a number of charitable and educational activities (the IRS did not argue that the organizational test was not satisfied), because those activities were incidental to its primary activity of operating a conference center in a commercial manner. The court stated the foundation carried out its business with a "distinctive 'commercial hue.'" Among the factors the court considered in assessing commerciality:
 - i. Competition with for-profit commercial entities
 - ii. Extent and degree of below cost services provided
 - iii. Pricing policies
 - iv. Reasonableness of financial reserves.
 - v. Use of commercial promotional methods (advertising)
 - vi. Extent to which the organization receives charitable donations.

vii. Nature of its clients.

- (5) In *American Institute for Economic Research v. United States*, 302 F.2d 934 (Ct. CL 1962), the Court considered the status of an organization that provided analysis of securities and industries and of the economic climate in general. It published two periodicals, sold subscriptions to various periodicals, and provided fee-based investment advice services for purchases of individual securities. The Court held that the service offered by the organization is one commonly associated with a commercial enterprise, was in competition with other commercial organizations providing similar services and its activities have a commercial hue. It also held the organization had primarily a non-exempt commercial purpose not incidental to its educational purpose and wasn't entitled to exemption under Section 501(c)(3).

D. Published Rulings and Court Opinions

- (1) Additional rulings and court cases are listed in the following subsections by category.

D.1. Charitable Purposes

- (1) Rev. Rul. 71-529, 1971-2 C.B. 234, states an organization providing assistance in the management of participating colleges' and universities' endowment or investment funds for a charge substantially below cost qualified for exemption under Section 501(c)(3). It obtained contributions to cover all or part of the costs of the management of such funds or to provide supplemental income or capital to be used exclusively for the charitable, educational, or scientific purposes of such organizations. Most of the operating expenses of the organization, including the costs of the services of the investment counselors and the custodian banks, are paid for by grants from independent charitable organizations. The member organizations pay only a nominal fee for the services performed. Membership in the organization was restricted to colleges and universities exempt under Section 501(c)(3) and the organization made its services available only to the exempt organizations (participating colleges and universities) controlling it.
- (2) In Rev. Rul. 72-369, 1972-2 C.B. 245, an organization was formed to provide managerial and consulting services to Section 501(c)(3) organizations. The organization entered into agreements with unrelated Section 501(c)(3) organizations to furnish managerial and consulting services on a cost basis. Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. Providing services at cost and solely to exempt organizations is not sufficient to characterize this activity as charitable within the meaning of Section 501(c)(3). Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable.

D.2. Unrelated Business Income

- (1) Rev. Rul. 73-587, 1973-2 C.B. 192 describes an exempt organization operating for the prevention of cruelty to animals. In furtherance of such purpose, it maintains and operates an animal shelter for the care, protection, placement, and, if necessary, humane disposal of stray or unwanted animals. The ruling provides the organization's provision of pet boarding and grooming services to the general public, for a fee, are ordinary commercial services, has no causal relationship to the prevention of cruelty to animals, and don't contribute importantly to the organization's exempt purpose. The operation of pet boarding and grooming services is regularly carried on. It constitutes the conduct of a trade or business. Therefore, the income earned from those services is from an unrelated trade or business.
- (2) In Rev. Rul. 69-430, 1969-2 C.B. 129, the organization engages primarily in activities in furtherance of its exempt purposes, but publication and distribution of a book will not contribute in any manner to the accomplishment of the exempt purposes. The organization has undertaken to exploit the book in a commercial manner. It has arranged for the printing, distribution, and retail sale of the book. The organization has also arranged for appropriate publicity and advertising in connection with the distribution and sale of the book. The income from the publication and sale of a book in the manner described, on a topic unrelated to the organization's exempt purpose, is unrelated business income.
- (3) Rev. Rul. 69-528, 1969-2 C.B. 127 concerns an organization formed to provide investment services for a fee exclusively to organizations exempt under Section 501(c)(3). The ruling stated the organization providing investment services for a fee on a regular basis is a trade or business ordinarily carried on for profit. The organization isn't described in Section 501(c)(3) since it's regularly carrying on the business of providing investment services that would be unrelated trade or business if carried on by any of the tax-exempt organizations on whose behalf it operates.

D.3. Substantial Non-exempt Purpose

- (1) In *Zagfly, Inc. v. Commissioner*, 603 F. Appx. 638 (9th Cir. 2015), the court of appeals found that the organization's primary activity of operating a web-based broker that sold flowers at market rates didn't accomplish one or more of the exempt purposes specified in Section 501(c)(3), but rather a commercial activity that amounted to an unrelated trade or business. When customers purchased flowers, they were able to designate a charitable organization from a list of approved organizations. The organization planned to donate the business profit arising from the transaction to charitable organizations. Organizations received a share of its profits only if the recipient was exempt under Section 501(c)(3). The organization hoped to expand web site offerings to include other goods and services. The court upheld the Tax Court's conclusion that the operational test wasn't met. Based on this, the court declined to address the unrelated trade or business analysis under Treas. Reg. 1.501(c)(3)-1(e).

(2) In *Easter House*, 12 Cl. Ct. 476, 60 AFTR2d 87-5119 (Cl. Ct., 1987), the organization provides services for unwed mothers and children incident to its operation of an adoption service. The adoption agency's application for tax-exempt status under Section 501(c)(3) was denied on the basis that the agency operated as a trade or business competing with and in a manner not "distinguishable from commercial adoption agency," and this was its primary purpose. The court indicated the following items in the record supported the ruling:

- a. The agency made substantial profits by charging substantial fees, which was its only source of income.
- b. There was substantial accumulation of capital surplus in comparison to direct expenditures by the agency for charitable and educational purposes.
- c. The operation was funded completely by substantial fixed fees charged adoptive parents and it never solicited or planned to solicit charitable contributions.
- d. Fixed fees charged adoptive parents were not subject to downward adjustment to meet potential adoptive parents' income or ability to pay.
- e. The organization was structured and operated like a commercial organization.

Note: The court also held there was inurement (pp. 488-89) in this case. Therefore, the organization couldn't qualify under Section 501(c)(3).

III. Other Considerations

(1) There are some common trade or business activities that tax-exempt organizations engage in which are considered unrelated trade or business and subject to tax. This section addresses advertising, partnership activity, and feeder organizations.

A. Advertising

- (1) A common issue in trade or business activities is the sale of advertising in publications of newsletters, journals or periodicals that contain editorial content distributed to members and the general public.
- (2) The publication and dissemination of the editorial content contributes importantly to the organization's exempt purpose. However, the sale of advertising in the publications is a trade or business activity that isn't related to their exempt purpose.
- (3) See Sections II.B.4, Regularly Carried On, and II.C.2, Substantially Related, of this TG for revenue rulings and court cases that address advertising issues.
- (4) Additionally, for a detailed discussion, see TG 48: Unrelated Business Income Tax.

B. Partnership Activity

- (1) Exempt organizations have used partnerships, both as an investment vehicle and to accomplish exempt purposes. While most exempt organizations carry on all their activities directly within their organizational structure, many exempt organizations choose to carry on some of their activities in other indirect ways. Some organizations decide to create wholly owned taxable subsidiaries for both tax and non-tax reasons. Such a taxable entity often serves as a repository for what would otherwise constitute an unrelated trade or business under Section 513(a) if it were conducted directly by the exempt organization. Other exempt organizations may choose to participate in a partnership, again for both tax and non-tax reasons. An exempt organization's participation in a partnership may take the form of either a general or a limited partner.
- (2) An exempt organization's receipts from partnership activity results in unrelated business taxable income (UBTI) under Section 512(c)(1):

“In general, if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.”
- (3) A partnership may generate two basic categories of potentially taxable income for an organization:
 - a. Fees for services provided to the partnership, and
 - b. Allocations of partnership income.
- (4) Rulings related to partnership interests and treatment of income include:
 - a. Rev. Rul. 79-222, 1979-2 C.B. 236 provides that the "look through" rule of Section 512(c) for determining the taxation of partnership distributions applies regardless of whether the interest held by the exempt organization is that of a limited or general partner.
 - b. In *Service Bolt and Nut Co. Profit Sharing Trust v. Commissioner*, 78 T.C. 812 (1982), *aff'd* 724 F.2d 519 (6th Cir. 1983), the courts held the income received from limited partnership interests constituted unrelated business taxable income.
- (5) For a detailed discussion, see TG 48: Unrelated Business Income Tax.

C. Feeder Organizations

- (1) Section 502, Feeder Organizations, was enacted to deny exemption to organizations whose primary purpose is to carry on a trade or business for profit

and turn over such profits to one or more exempt organizations. Enactment resulted from concern that:

- a. Such organizations weren't themselves carrying out an exempt purpose, and
- b. Trade or business activities were being conducted in direct competition with other taxable businesses.

C.1. Primary Purpose Test

- (1) A feeder organization operates for the primary purpose of carrying on a trade or business for profit, the income from which is turned over or fed to a Section 501(c)(3) organization.
- (2) If an organization's principal income-producing activity is the conduct of a trade or business, and it has no significant charitable activity other than the payment of its profits over to one or more exempt organizations, it's operated for the primary purpose of carrying on a trade or business for profit within the meaning of Section 502 and won't qualify for exemption under Section 501(c)(3).
- (3) This primary purpose test is concerned with how much business activity constitutes primarily engaged in a trade or business. What constitutes a trade or business for profit has not been strictly defined under Section 502, although it's clear that this test involves the evaluation of the facts and circumstances in each case, including the size and extent of the trade or business and the size and extent of the exempt activities. See Treas. Reg. 1.502-1(a).
- (4) An example of the primary purpose issue is found in Rev. Rul. 73-164, 1973-1 C.B. 223:

A church formed a separate organization to promote and provide financial support for its charitable programs. The organization accomplished its exempt purpose by printing religious materials for the church at cost.

- a. The publishing function for church materials accounted for approximately 10 percent of the organization's overall publishing activities.
- b. The remaining 90 percent was devoted to the operation of a commercial printing business, from which all of the organization's substantial profits were derived.
- c. The organization paid over all the net income to the church at the end of each calendar quarter of operation.

Although the organization may be said to be organized and operated exclusively for charitable purposes because the use of all of its assets is effectively dedicated to exclusively charitable objects, its only basis for qualifying, apart from the relatively insignificant amount of printing performed at cost for the church, is that all of its profits are required to be paid to the church. Since the organization has no other significant charitable activity and its

principal income-producing activity is the conduct of a trade or business, it's precluded from exemption under Section 501(c)(3) by reason of Section 502.

C.2. Trade or Business Defined

- (1) Under Section 513, the term "trade or business" is defined as any activity which is carried on for the production of income from the sale of goods or the performance of services.
- (2) This includes any activity carried on for the production of income and which otherwise possess the characteristics required to constitute a trade or business within the meaning of Section 162 and which, in addition, is not substantially related to the performance of the exempt functions. Treas. Reg. 1.513-1(b).
- (3) Thus, as a general rule, an activity that qualifies as a trade or business under Section 162 also qualifies as a trade or business under Section 513. Treas. Reg. 1.513-1(b).

C.3. Exceptions to Trade or Business

- (1) For purposes of feeder organizations, the term trade or business (for taxable years beginning after December 31, 1969) doesn't include Treas. Reg. 1.502-1(d)(2).
 - a. The deriving of rents described in Section 512(b)(3)(A) (unless the rents derived by an organization wouldn't be excluded from unrelated business income under Section 512(b)(3) and regulations)
 - b. Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation
 - c. Any trade or business (such as a thrift shop) which consists of the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

C.4. Profit Motive Test

- (1) Section 162 permits a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable period in carrying on a trade or business.
- (2) Thus, if an organization's motive or intent for engaging in an activity is the production of income, then that activity constitutes a trade or business. However, the absence of profit alone won't prevent an enterprise from being classified as a trade or business.
- (3) For example, in *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the court held that a Section 501(c)(3) organization's insurance program operated like a commercial entity and was a trade or business for purposes of tax on unrelated business income. See prior Section II.B.3(3) – (5) for a detailed discussion of the case.

C.5. Subsidiary-Integral Part of Parent

- (1) Treas. Reg. 1.502-1(b) provides that if an exempt organization's subsidiary organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption won't be lost because, as a matter of accounting between the two organizations, the subsidiary makes a profit from its dealings with the parent.

C.6. Subsidiary-Trade or Business

- (1) Treas. Reg. 1.502-1(b) further states that the subsidiary organization isn't exempt from tax if it's operated primarily for the purpose of carrying on an unrelated trade or business if regularly carried on by the parent organization.

C.7. Subsidiary-Relationship Test

- (1) For purposes of Treas. Reg. 1.502-1(b), organizations are related only if they consist of:
 - a. A parent organization and one or more of its subsidiary organizations, or
 - b. Subsidiary organizations having a common parent organization.
- (2) The regulation provides that an exempt organization isn't related to another exempt organization merely because they both engage in the same type of exempt activities.
- (3) However, a strict parent-subsidiary relationship isn't required for organizations to be considered "related" within the meaning of Treas. Reg. 1.502-1(b).
- (4) For example, in Rev. Rul. 68-26, 1968-1 CB 272, a church-controlled subsidiary (incorporated without stock by the church) that printed standardized educational and religious material for the church's parochial school system, prepared and edited by the school system, and sold the materials only to that system isn't a feeder organization described in Section 502. The ruling states that although a technical parent-subsidiary relationship is lacking due to the nonstock character of the subsidiary, a substantially similar relationship exists through the control and close supervision" of the subsidiary's affairs by the church. The subsidiary is carrying out an integral part of the activities of the church.

C.8. Services to Exempt Organizations

- (1) Some organizations aren't engaged in a business to make money for designated charitable organizations but are organized and operated to provide services for specific charitable organizations.
- (2) Rev. Rul. 54-305, 1954-2 C.B. 127, describes a corporation organized and operated for the primary purpose of operating and maintaining a supply purchasing agency for the benefit of its otherwise unrelated members exempt from Federal income tax as charitable organizations. The organization secured for hospitals and other charitable institutions the advantages of cooperation in establishing uniform standards as to quality and kind of supplies and promoted

the economical and efficient administration of hospitals. Substantial profits are realized by the organization from these services. Only a portion of such profits are distributed by the organization to its members (charitable hospitals). The organization was found to be engaged in business activities which would be unrelated activities if carried on by any one of the tax-exempt organizations served and thus not exempt from UBIT.

- (3) Section 501(e) provides exemption for certain cooperative hospital service organizations for taxable years ending after June 28, 1968. Organizations outside the scope of Section 501(e), such as those hospital service organizations providing laundry services, are still subject to Section 502.
- (4) Section 501(f) provides exemption for certain cooperative investment service organizations organized and controlled by organizations described in either Section 170(b)(1)(A)(ii) (schools) or 170(b)(1)(A)(iv) (certain organizations that support schools) for the collective investment of their funds in stocks and securities. Section 501(f) applies only to taxable years ending after December 31, 1973.

C.9. Other Resources

- (1) Additional sources of information include:
 - a. CPE 1983-F, IRC 502 - Feeder Organizations
 - b. Exempt Organizations Determinations Training-Unit 2, Lesson 5, Advanced Fundraising Issues
 - c. Training 11231-002 (Rev. 5-2006) TEGE EO Examinations Advanced-Module B, Lesson 8, IRC Section 502 Feeder Organizations.

D. Unrelated Business Taxable Income (UBTI) and Unrelated Business Income Tax (UBIT)

- (1) Section 511(a)(1) imposes a tax, computed as provided in Section 11, on the unrelated business taxable income of every organization described in Section 511(a)(2).
 - a. The tax applies to all organizations exempt under Sections 501(a), other than organizations described in Section 501(c)(1) or trusts described in 511(b), except as provided in this part (Part III, Subchapter F) or part II (relating to private foundations).
 - b. Section 501(c)(1) organizations are any corporations organized under an Act of Congress which are instrumentalities of the United States subject to specific requirements in Section 501(c)(1)(A) and (B).
 - c. The tax is also imposed upon the UBTI of state colleges and universities which is an agency or instrumentality of any government or any political subdivision thereof, which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or

more governments or political subdivisions, or any corporations wholly owned by one or more state college or university.

- (2) Exempt organizations subject to the unrelated business income tax imposed by Section 511(a) are organized either as a corporation or a trust.
- (3) In the case of corporations:
 - a. Through December 2017, the Section 11 rates on UBTI ranged from 15 percent to 35 percent. See Section 11 effective to December 21, 2017.
 - b. The Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97, Section 13001) changed the corporate tax rate range from 15 to 35 percent to one flat rate of 21 percent. This rate will be effective permanently for corporations (including exempt corporate organizations) whose tax year begins after January 1, 2018.
- (4) In the case of trusts:
 - a. Through December 2017, exempt organizations that are trusts were taxed on their unrelated business taxable income at the trust rates provided in Section 1(e). These rates ranged from 15% to 39.6%, depending on amount of taxable income. See Section 511(b).
 - b. The Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97, Section 11001) changed the rates. Effective January 1, 2018, through December 31, 2025, trusts will be taxed on their unrelated business taxable income at the trust rates provided in Section 1(j)(2)(E). The rates range from 10% to 37% .
- (5) Exempt organizations that have \$1,000 or more in gross receipts from an unrelated business activity must file Form 990-T, Exempt Organization Business Income Tax Return, on or before the 15th day of the 5th month of their taxable year. Treas. Reg. 1.6012-2(e). Even if an organization is specifically excluded from filing a Form 990 or 990 EZ, they must file Form 990-T if they have gross receipts of \$1,000 or more from an unrelated business activity (for example, churches or organizations that file the 990-N Electronic Postcard). See Section 511(a)(2)(A) and Treas. Reg. 1.6012-2(e).
- (6) Under Section 6104(d), a Section 501(c)(3) organization is required to disclose any return which is filed under Section 6011 by an organization described in Section 501(c)(3) and which relates to any tax imposed by Section 511 (relating to imposition of tax on UBI of charitable organizations).
- (7) See TG 48: Unrelated Business Income Tax.

IV. Examination Techniques

- (1) This section provides examination techniques to identify non-exempt trade or business activities and to determine if such activities jeopardize the organizations exempt status.

A. Organizational Test

- (1) In order to determine the exempt purposes of the organization, you must first go to the organizing document to see what purposes/activities the organization was formed for.
- (2) Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, Part IV, Your Activities, asks applicants to describe their past, present, and planned activities in a narrative and asks applicants to complete a series of "Yes" or "No" questions regarding their specific activities. This information should be closely reviewed in order to determine:
 - a. Whether the activities are conducted to further one or more exempt purposes, and
 - b. Whether the activities further a non-exempt purpose.
- (3) Review the organization bylaws, as they often contain purposes and goals of the organization.
- (4) If a non-exempt purpose exists, the specialist must determine if the non-exempt purpose is substantial.
 - a. If the non-exempt purpose is substantial, the organization won't meet the operational test for exemption under Section 501(c)(3).
 - b. If the non-exempt activity is incidental, it won't result in denial of exemption.
- (5) If the non-exempt activity is substantial and constitutes a necessary part of its activities in order to achieve its purpose, consideration might be given to exemption under another subsection.
- (6) See IRM 7.20 Exempt Organizations Determinations Letter Program.

B. Operational Test

- (1) The following examination techniques can be used in identifying trade or business activities conducted by an exempt organization:
 - a. Review the Form 990 series return and take note of such items like the organization's mission and activities, employees, volunteers, change in programs, and any unrelated business income.
 - b. Review the financial information and determine if the income, expenses, and assets are appropriate for the organization's exempt functions, or is a trade or business indicated.

- c. Tour facilities to identify possible trade or business activities.
 - d. Review newsletters and other publications for indications of unrelated trade or business (including advertising).
 - e. Review organization's website for other indications of unrelated trade or business (including advertising).
 - f. Review the books and records for revenues and expenses indicating the organization is conducting a business operation.
 - g. Review minutes from board meetings.
- (2) The following examination techniques can be used in determining whether an activity is conducted by an exempt organization as a trade or business with intent to make a profit:
- a. Interview the CEO and other personnel responsible for conducting the activity on why and how the activity is conducted. This will help to consider all facts and circumstances when determining whether there is a profit motive for conducting the activity.
 - b. Tour the facilities to actually observe the activity.
 - c. Isolate the financial transactions of the activity to determine whether the activity resulted in a profit or loss. A good starting point is to analyze the activity budget or departmental schedules of the financial statements.
 - d. Review the minutes of the organization to establish the intent of the activity and for progress reports on the activity.
 - e. Chart the profit and loss of the activity over several years to determine how financially successful the activity has been.
- (3) The following examination techniques can be used to determine whether an activity is "regularly carried on":
- a. Ask questions regarding how the activity is conducted.
 - b. Review the minutes of the organization for information describing the expectations and timetable for the activity.
 - c. Request all pertinent documentation concerning the conduct of the activity such as procedures, publications, and contracts.
 - d. Compare the way the activity is conducted by the tax-exempt organization to the way the same type of activity is conducted by a for-profit entity. The comparison should be both financial and operational.
- (4) Use these examination techniques to determine whether an activity is substantially related to the organization's exempt purpose:
- a. Review the board minutes for information relating to activities.
 - b. Request all pertinent documentation concerning the conduct of the activity (e.g., procedures, publications, contracts).

- c. Compare the way the activity is conducted by the tax-exempt organization to the way the same type of activity is conducted by a for-profit entity. The comparison should be both financial and operational.
- (5) To determine whether an unrelated trade or business qualifies for the general exceptions of Section 513(a), use the following examination techniques:
- a. Interview organization officers about how the activity is conducted. to determine the motive for conducting the activity.
 - b. Interview employees who conduct the activity to find out where and how the activity is conducted.
 - c. Tour the facilities to observe the conduct of the activity and the amount of general public patronage.
 - d. Review the minutes of the organization for information describing the expectations and results of the activity.
 - e. Request all documentation concerning the conduct of the activity such as procedures, publications, contracts, volunteer time records, acknowledgments, and values of contributed merchandise.
 - f. In order to determine the scope of the activity, compare the way the activity is conducted by the tax-exempt organization to the way the same type of activity is conducted by a for-profit entity. The comparison should be both financial and operational.
- (6) To determine whether an unrelated trade or business qualifies for the special exceptions of Section 513(d)-(i), use the following examination techniques:
- a. Check for any recent change in legislation or interpretation.
 - b. Interview relevant officers and employees early and often during the examination to understand exactly how the activity is being conducted.
 - c. Review the minutes of the organization for information describing the expectations and results of the activity.
 - d. Secure copies of all documentation concerning the procedures and operation of the activity including, but not limited to, periodicals, advertisements, acknowledgments, video tapes, audio tapes, brochures, programs, contracts, lease agreements, and any other materials that will describe the activity or event.
 - e. If applicable, tour the facilities to observe the conduct of the activity to ensure that the organizations are qualified organizations, and that the activity is being conducted in a manner consistent with the special exceptions under Section 513 paragraphs (d)-(i).
 - f. Isolate the financial transactions of the exempt activity and the unrelated business activity starting with the financial statements. Often this information will be in schedules to the financial statements. If the activity is

reported as UBI, the accountant will have tax workpapers that have isolated the activity's financial transactions.

g. If the activity hasn't been reported as UBI, and the activities aren't scheduled in the financial statements or any other reliable documents, analyze the books and records to identify the sources of income for the exempt activity and the unrelated business activity. The expenses should be analyzed to match the expenses with the appropriate sources of income.

h. Even though the organization may have the financial transactions of the activities isolated, you still need to apply the first six audit steps listed here to ensure the information is accurate and complete.

(7) See IRM 4.70 TE/GE Examinations

V. Additional Resources

(1) Publication 557, Tax-Exempt Status For Your Organization

(2) Publication 598, Tax on Unrelated Business Income of Exempt Organizations

(3) Publication 4221-PC, Compliance Guide for 501(c)(3) Public Charities

(4) Publication 4221-PF, Compliance Guide for 501(c)(3) Private Foundations

(5) EO Determinations Training, Unit 1A, Lesson 9-501(c)(3) Operational Test; Lesson 16, Introduction to Unrelated Business Income (UBI)

(6) Exempt Organizations Examinations (Basic) Training – Part 1, Module A, Unrelated Business Income (Training 70219-002) (4-2019)

(7) Exempt Organizations, Examinations-Advanced, Module C-Unrelated Trade or Business, Sections 511 and 513 (Training 11231-004) (5-2006) (Catalog Number 47887D)

(8) TG 3-1: Overview, Applications, Exemption Requirements Section 501(c)(3)

(9) TG 48: Unrelated Business Income Tax