

FEDERAL TAX ON UNRELATED BUSINESS INCOME

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In response to a question asked by one of our museum members, it is not illegal for a tax exempt organization to engage in business activity not directly related to the organization's exempt purpose. In this case it was the proposed sale in the museum store of articles not related to the museum's mission. While not unlawful, the sale of such articles could give rise to liability for unrelated business income tax, and to the burden of doing the bookkeeping necessary to segregate such income and the expenses relating thereto from the other income and expenses which are related to the museum's mission.

Generally a tax-exempt organization with gross income of \$1000 or more for the year from an unrelated trade or business must file a tax return (Form 990-T *Exempt Organization Business Income Tax Return*) and pay any tax due. Note that Form 990T may be required even if the gross receipts of the exempt organization for the year are less than \$25,000 and the organization is not required to file a Form 990.

A basic principal that establishes exemption from Federal income taxes is that the organization is exempt only if its primary purpose is to engage in the type of activity for which it claims exemption. Many exempt organizations operate a trade or business which furthers their exempt purpose. Some exempt organizations operate a trade or business which has little or no relationship to their exempt purpose, except to provide funds to carry out their exempt purpose. The income from such unrelated trade or business is subject to Federal income tax at the same rates as are applicable to for-profit corporations.¹

Before the provisions for taxing income from an unrelated business apply, the trade or business must be one that is regularly carried on and not substantially related to carrying out the exempt purposes for which the organization exists. The fact that the organization needs and uses the profits from the unrelated business to support its exempt purpose does not make the business activity "substantially related."

To produce unrelated business income the activity must be regularly carried on. For example the friends of the museum operate a sandwich stand for two weeks at the county fair. The stand would not compete with similar facilities that a taxpaying organization would ordinarily operate year-round. However, the operation of a commercial parking lot every evening when the museum was not open to the public would be the regular conduct of a trade or business. Note that the rationale of taxing unrelated business income of tax exempt organizations is to avoid having the tax exempt organization use its tax exempt status to unfairly compete with taxpaying organizations that must pay income tax on their profits.

To determine whether or not a business activity is substantially related to the organization's exempt purpose requires an examination of the relationship between the activity which generates the income and the accomplishment of the organization's exempt purpose. The IRS requires that the causal relationship be substantial. The activities that generate the income must *contribute importantly* to the organization's exempt purpose.

¹ This is a graduated tax starting at 15% of the first \$50,000 of taxable income and increasing in steps to 35% of amounts over \$18,333,333.

In determining whether activities *contribute importantly* to the accomplishment of an exempt purpose, the size and nature of the activities involved must be considered in relationship to the nature and extent of the exempt purpose they are intended to serve.

The “*contributes importantly*” principle as it relates to the activities of an exempt organization, particularly museums, can best be explained by a few examples.

A museum operates a dining room, a snack bar, and an espresso stand for use by staff members, employees and members of the public visiting the museum. (Note: not the public at large.) These activities do not constitute an unrelated trade or business. The eating facilities within the museum help attract visitors to the museum exhibits: because there are places of refreshment within the facility visitors are able to spend more of their time viewing the museum exhibits and other educational facilities than they would if they had to stop their tours to seek outside restaurants. The museum's operation of eating facilities therefore contributes importantly to the accomplishment of its exempt purpose.

A history museum operates a blacksmith shop as part of a living history program. It also sells articles made in the blacksmith shop in the museum store. The sale of such articles in the museum store does not constitute an unrelated trade or business since the articles directly relate to the museum's exempt purpose.

An art museum sells to the general public greeting cards that display printed reproductions of selected works from its and other art collections. Each card is imprinted with the name of the artist, the title or subject matter of the work, and the date or period of its creation. The card contains appropriate greetings or may be personalized. The sale of such greeting cards and reproductions contributes importantly to the museum's exempt educational purpose by enhancing public awareness, interest, and appreciation of art. The same applies to the sale of historic reproductions, cards of historic scenes and copies of historic photographs sold in the stores of heritage museums. Such items may also be sold by mail through catalogues. That such material may also be sold in a commercial manner at a profit and in competition with commercial greeting card companies does not alter the fact that the activity is related to the museum's exempt purpose; therefore, such 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 have no relationship to arts or to history and therefore the sale of these items does not contribute importantly to the accomplishment of the museum's exempt educational purpose in the arts or in history even though in a different museum context they might do so.

There are certain activities that are specifically excluded from the definition of unrelated trade or business.

Volunteer labor. Any trade or business is excluded in which substantially all the work is performed for the organization without compensation. A good example is a museum store in which volunteers perform substantially all of the work.

Donated merchandise. Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization receives as gifts or contributions. A thrift shop that a tax exempt organization operates which sells donated clothing and books to the general public with the proceeds going to the exempt organization is not an unrelated trade or business.

Bingo games. Certain bingo games are not included in the term "unrelated trade or business" provided the game is legal and is not conducted in a jurisdiction in which bingo games are ordinarily carried out on a commercial basis.

Certain other activities may or may not be unrelated trade or business activities:

Mailing lists. The sale or rental of membership or donor mailing lists for commercial purposes is an unrelated business activity; however, the rental or exchange of mailing lists or donor lists between exempt non-profit organizations is not an unrelated business activity.

Tours. Many exempt organizations now offer tours to their members and to the public. If the tour has a theme, e.g. to see certain historic sites, or art exhibits or to attend certain performing art events and is accompanied by knowledgeable guides and lectures and instructional material, they may be in furtherance of the museum's tax exempt purpose. However, if the tour offers no more than an itinerary, even one related to the museum's exempt purpose it will be treated as a unrelated trade or business since the exempt organization is offering no more services than that of a travel agency.

Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger complex of other endeavors that may or may not be related to the exempt purpose of the organization. For example, a museum may publish a periodical whose editorial content is directly related to the museum's tax exempt mission. Part of publishing the periodical may be soliciting, selling, and publishing commercial advertising. The net income from the sale of such advertising is unrelated business income and is subject to tax. The museum will have to segregate the expenses of soliciting, selling and publishing the commercial advertisement so as to claim such costs as an offset against the gross income received by reason of the advertising. For more details on the treatment of advertising costs and advertising income see Chapter 3 of IRS Publication 598, "Tax on Unrelated Business Income of Exempt Organizations."

Advertising income is considered to be an unrelated business; however, the acknowledgement of sponsorship of an event or an exhibit is not considered advertising. The test here is whether the nature of the acknowledgement such that can reasonably be said to attract business rather than just public good will.

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