Unrelated Business Income Taxes
What the Federal Courts Have Said
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BY

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INTRODUCTION:

Several issues impact the management of accounting for large not-for-profit organizations that would not arise normally in a regular for-profit corporation. These issues vary widely from how much annual salary the executives rightfully deserve as compensation to the way the organization raises funds for its day-to-day activities. Slightly less common, but still very important, is the issue of taxes. Yes, not-for-profit corporations have to pay taxes, but only on certain forms of revenue. In many instances, large not-for-profit corporations operate similar to a for-profit firm. The money not-for-profits have to pay tax on falls under the Internal Revenue Code sections 511 through section 513 described as the Unrelated Business Taxable Income (UBIT). This thesis article focuses on the history of the UBIT and the case law that has been decided over the years in the federal courts.

HISTORY:

The Wilson-Gorman Tariff Act of 1984, although declared unconstitutional by the Supreme Court in 1896, was the original beginning of any businesses having tax-exempt status. The act "established a flat, 2-percent tax on corporate income but excluded corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes, including fraternal beneficiary associations" (Arnsberger, Ludlum, Riley, & Stanton, 2008). Congress created the Revenue Act of 1913 establishing "the modern income tax system" (Arnsberger et al., 2008). The tax laws continued to develop during the early twentieth century with only minor restrictions on charitable organizations. This created a major tax loophole for not-for-profits to operate for-profit firms to produce steady income streams. In 1950, Congress introduced

its new revenue laws creating the first unrelated business income tax on not-for-profit firms. Finally in 1954, Congress spelled out exactly what was considered a not-for-profit organization for tax-exemption purposes.

The Revenue Code of 1954 provides a provision for income tax exemption to certain income producing entities, known as not-for-profit entities, in section 501. Majority of not-for-profit organizations are organized under code section 501 (c) (3) (See Appendix A). This tax exemption is granted based on the premise that the organization is operating with the goal to provide a service to the general public and society as a whole and not for a profit motive. Also, no member of the organization is allowed to receive any excess funds that the organization may have accumulated at the end of the year. This is in direct contrast to the operational activities of a traditional for-profit organization, whose sole mission is to earn a profit for the owners after all the organization's expenses have been paid.

Tax-exempt entities generally fall into one of two categories: a private foundation or a public charity. The distinguishing feature between the two entity types is the source of the organizations founding (Foundation Center, 2010). A private foundation is typically funded and controlled by one family or a small group of individuals to conduct its tax-exempt purpose. Many private foundations are controlled by for-profit corporations to show that the company is trying to give back to the community. "A private foundation does not solicit funds from the public" (Foundation Center, 2010). As opposed to a private foundation, public charities are mainly funded by government grants and donations that are raised from the general public through fundraisers. "Not every

organization that uses the word foundation in its name is a private foundation" (Foundation Center, 2010).

Congress originally created the unrelated business income tax provisions in 1950, mainly in an attempt to prevent the "unfair competition" that existed between the not-for-profit organizations and the regular for-profit businesses (Yetman, 2001). Before then, a not-for-profit organization could own a for-profit business and effectively avoid all income taxes on the profits earned by that business. This gave the not-for-profit a long-term, sustainable competitive advantage in the market that was not obtainable by any firm that was forced to pay taxes on earned income.

The company most commonly mentioned when discussing an unfair competition by a not-for-profit organization is New York University (NYU) owning the Mueller Macaroni Company. NYU alumni purchased the Mueller Macaroni Company in 1947 and donated it to the university (N.Y.U's Macaroni, 1950). By being entirely owned by a not-for-profit university, Mueller Macaroni Company effectively became a not-for-profit company. Since no one was paying taxes on the money earned from selling the macaroni, Mueller had an unfair sustainable competitive advantage in the marketplace. This competitive advantage allowed NYU to earn a greater profit than a for-profit firm could have made by owning the company, and therefore gave NYU a nice return on investment.

WHAT IS UBIT?

Unrelated business income is any income realized by a tax-exempt entity not resulting from a business activity directly pertaining to the tax-exempt entity's exempt purpose as provided for in section 501 subsection b of the Internal Revenue Code.

Section 511 of the Internal Revenue Code is the portion of the law that imposes a tax on not-for-profit organizations and defines what organizations are going to fall under the tax (Appendix B). Section 512 of the Internal Revenue Code lays out what revenue streams fall under the UBIT laws, and therefore section 512 spells out what the not-for-profits have to pay taxes on. As defined in Section 512 of the Internal Revenue Code:

> Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b) (IRC §512).

Section 513 of the Internal Revenue Code continues by spelling out the exceptions to the amounts that are taxed in Section 512. The three general exceptions from Section 513 are income from a trade or business where substantially all the work involved with the activity is performed for by volunteers for organization without compensation, when the activity is conducted for the convenience of the organizations members, or when the activity involves selling donated merchandise. An example of an activity carried on for the convenience of organization members is when a not-for-profit chamber of commerce organization holds a dinner to provide its members with the opportunity to network with each other. The chamber of commerce tax-exempt mission is to promote business in the community. Even though they may make money from the dinner, it is not subject to the UBIT because it is an activity held for the convenience of members. Section 514 is dedicated entirely to income that is obtained through debt-financed property. "The term debt-financed property means any property which is held to produce income and with respect to which there is acquisition indebtedness at any time during the year" (IRC

§514). Simply put, if the property is purchased using financing, all income earned from that property is subject to the UBIT until the entire amount of debt is repaid.

The Internal Revenue Service (IRS) looks at three main issues when determining the taxable status of a tax-exempt entity's income as being unrelated business income:

1. "Trade or Business"
2. "Regularly Carried On"
3. "Not Substantially Related"

The definition of trade or business encompasses any activity that is carried on by the tax-exempt organization for the production of profit. This includes all activities carried on by an organization. The IRS has ruled that an activity does not lose its classification as a separate trade or business activity because it is a small part of a larger activity conducted by the tax-exempt entity. The second question about the UBIT concerns the frequency of the business activity. The IRS is concerned with the amount of time the tax-exempt organization spends operating the activity compared to the amount of time a commercial entity would spend operating a similar activity. The example listed given by the IRS deals with a state fair sandwich stand. "The operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business" (Tres. Reg. §1.513-1). Lastly, the UBIT concerns the relationship between the business activity and the tax-exempt organization's exempt purpose. This relationship must concern the physical operations of the tax exempt entity's purpose.

Simply providing financing to the tax-exempt organization does not qualify as substantially related to the entity's purpose. The activity must have a causal relationship to the not-for-profit organization's tax-exempt mission. An example of a substantially related activity would be an art school selling students' artwork. This provides funds for the school, but more importantly, it provides students the opportunity to sell their masterpieces.

CURRENT ECONOMY EFFECTS:

Not-for-profit organizations, as well as most individuals and business, are currently feeling the effects of the economic recession. Many organizations are being forced to look toward non-traditional financing sources in order to continue to operate their day-to-day activities. This change in funding sources is causing many not-for-profit organizations that have never had to deal with the unrelated business income tax laws to now have income that is considered by the internal revenue service to be unrelated business taxable income.

Executive and employee compensation is becoming an issue for many not-for-profit firms. This becomes an issue because not-for-profit organizations "are legally required to avoid providing unreasonable compensation to executives and board members. Recently, Congress and various independent organizations have proposed legislation aimed to further define and limit permitted compensation amounts" (Arnsberger, Ludlum, & Riley, 2005). Not-for-profit organizations must now try to retain their top management and employees who are being offered higher salaries from private sector industries that are starting to recover from the recession.

LITERATURE SEARCH:

Despite the charitable missions of many not-for-profit organizations, these organizations are becoming more like a regular for-profit corporation and questions arise regarding whether these organizations rightfully still deserve their tax-exempt status. The IRS developed a Compliance Questionnaire survey to college and universities around the country in October 2008 to help determine if the colleges and universities surveyed are using their tax-exempt status appropriately. Currently the IRS is only focusing on colleges and universities with its compliance questionnaire checks, but other not-for-profit organizations should be prepared for the IRS to start looking in other areas (Patton & Bishop, 2009).

In response to several inquires about the validity of these tax-exempt organizations, Congress and the IRS have begun delving much deeper into the financial statements and the Form 990's of the not-for-profit organizations. They are attempting to determine if the organizations are still deserving of their tax-exempt status and if they are paying the amount of unrelated business income taxes that they owe (Patton & Bishop, 2009).

The IRS has long questioned the validity of deductions that the not-for-profits have claimed against any reported unrelated business income. An IRS survey in 2004 found that not-for-profits claimed nine billion dollars of deductions on only nine and a half billion dollars of gross unrelated business income (Patton & Bishop, 2009). Effectively, the not-for-profit corporations were paying very little taxes on their unrelated business income. The studies tend to show that not-for-profits continue to allocate expenses from tax-exempt activities to what are unrelated business activities. With the state of the current economy forcing more non-profits to have unrelated business income,

expect to see a continued growth in the amount of this misallocation of expenses for the not-for-profit organizations to continue to avoid having to pay the taxes that they owe.

Many other developments in the not-for-profit accounting field are currently being debated. These include the debate over whether not-for-profits are over allocating expenses to the taxable income, if not-for-profits are using offshore corporations to shield unrelated business income for taxes here in the United States, the IRS is focusing heavily on the amount of revenue produced by college athletics, and the IRS data complied from not-for-profit tax returns (Form 990 and Form 990-T) appears to show a trend of inaccurate reporting by non-profit corporations (Patton & Bishop, 2009).

Another study focuses on the allocation of expenses by not-for-profit organizations and whether not-for-profits are over allocating expenses to the taxable unrelated business income. This study defines what the unrelated business income tax is, what constitutes taxable income for a not-for-profit organization, and what Congress's reasoning is for imposing a tax on tax exempt organizations (Yetman, 2001). This is because the majority of the people outside the not-for-profit industry does not know that even though they are considered tax-exempt, they are required to pay tax on income they receive from unrelated sources. Most people normally just assume that the tax-exempt status applies to all the money received by the tax-exempt organization.

Yetman's study was the first statistical analysis of the expenses allocation to unrelated business taxable income. Yetman study assumes two principles: "1) Nonprofits do not shift revenues across tax-exempt and taxable activities. 2) Expenses are proportional to revenues" (Yetman, 2001). He obtained matching tax returns (Form 990

and Form 990T) from over 700 nonprofit organizations throughout the United States (Yetman, 2001).

To perform his data analysis, Yetman separated not-for-profits into a medical not-for-profit category, an education non-profit category, and a charitable not-for-profit category. The results reveal that while some segments of the not-for-profit industry appear to be shifting expenses between taxable revenue and non-taxable revenue, others show no apparent expense shifting. The data shows that medical not-for-profits misallocated an average of 405 thousand dollars in expenses from non-taxable sources to taxable income. Furthermore, educational institutions also have been misallocating expense by an average of 101 thousand dollars. Further analysis shows no apparent misallocation of expenses by charitable not-for-profit organizations (Yetman, 2001).

The study results show that in aggregate not-for-profits are operating with a 50 billion dollar gain on their tax-exempt core operations. On the other hand, these organizations are showing a loss of over 1 billion dollars on the taxable unrelated business income items (Yetman, 2001). Unless expenses are being misallocated, why else would the not-for-profits continue to operate a business that is losing money and is not directly related to their core mission for which they have the tax-exempt status?

Another study looks at how the Financial Accounting Standards Board (FASB) treats uncertain income tax positions corporations are in. One uncertain tax position in question is whether income falls in the spectrum of taxable or tax-exempt income for a not-for-profit corporation. This study contains the only analysis of how not-for-profits are to treat unrelated business income when preparing financial statements according the United States' Generally Accepted Accounting Principles (GAAP). According to GAAP,

FIN 48 applies to not-for-profit organizations when the questionable activity's "Usage falls somewhere between the extremes…and the entity takes the position that the income is not UBIT" (Alltizer, McAllister, & Jarnagin, 2008). To determine where in the spectrum of the issue being taxable or not, the corporation must determine the probabilities for all outcomes that can occur. Only when the organization determines that unrelated business income "is more likely than not" to become taxable, then the organization is required to recognize the tax liability in their financial reports (Alltizer et al., 2008).

How not-for-profit corporations who have a controlling interest in a normal for-profit organization is discussed in Section 512(b)(13). The code treats the taxes not-for-profit organizations more harshly when they are dealing with a controlled entity than when they are dealing with another outside firm. This is the result of a corporation being able to set artificial favorable values for transactions when it owns the second party involved in the transaction. The tax code says that whenever a not-for-profit organization receives a specified payment ("interest, annuity, royalty, or rent") from a controlled entity it automatically becomes unrelated business income that is not tax-exempt to the extent that the taxable controlled entity's net income is reduced. This part of the law was written to close the loophole that would have provided an incentive for not-for-profits to have more business dealing with their for-profit subsidies. By shifting income from the for-profit entity through this specified payments, the for-profit firm would not be taxed on the money nor would the not-for-profit firm.

Some researchers argue in favor of Congress rewriting the tax rules and allowing the not-for-profit organizations to treat these types of transactions as they would treat any

other transaction with a non-controlled firm as long as the transaction can meet the arm's-length rules that state the transaction is for some form of service at the fair market value of that service. Currently, "Payments made at below-market value from taxable or noncharitable entities to charitable entities to charitable entities are inherently instances of private inurement and can subject organizations to the risk of sanction, including loss of exemption for the charitable organization" (Lowenthal, 2009). In his research, Lowenthal discusses the many issues that come up when entering into a contractual relationship between a not-for-profit entity and a controlled for-profit subsidy corporation (Lowenthal, 2009).

Henry Hansmann's research looks at the oldest argument there is about unrelated business income tax. He looked at objections made in the 1980's by the business community to the unfair competitive advantage that a not-for-profit firm had by being tax-exempt. While Hansmann's research is over twenty years old, the tax laws concerning the unrelated business income have yet to be overhauled as businesses wanted in the late 1980's, and as many businesses would still like to see happen today. The same unfair competitive advantage that existed for not-for-profit organizations by being tax-exempt in the 1980's has not disappeared (Hansmann, 1989).

Hansmann's research examines the evidence surrounding the unrelated business income tax policy and how it should be overhauled to protect both for-profit businesses as well as the United States tax revenue base. Hansmann classifies unrelated business income into two categories, income that results in an economy of scope and income that does not. He uses the example of a university renting out its football stadium to a pro team for summer practice. The university experiences very little added cost over the cost

to just use the football stadium for its collegiate team. This is what he calls an economy of scope. By contrast, there was no economy of scope in New York University's owning the Mueller Macaroni Company for over forty years (Hansmann, 1989).

Hansmann's research ponders the results of not having an unrelated business income tax for not-for-profit corporations. In order to achieve this, he looks back to the arguments that existed about unfair competitive advantages in the 1940's before the unrelated business income laws were created by Congress. Business owners argued that unless not-for-profit organizations were taxed, they would be able to use this cost advantage to drive for-profit firms out of business and control entire industry segments. The argument is that the not-for-profit organizations have an incentive to lower prices to gain market share. According to Hansmann, this is the exact opposite of what a not-for-profit firm would do because they want to avoid attention and not risk losing their tax-exempt status and being taxed on all of their revenue. Hansmann reached the conclusion that the case is weak for repealing the unrelated business income tax rules or for considerably expanding the unrelated business income. Hansmann agrees that the unrelated business income rules need overhauled to meet the new economic challenges in the world but not considerably change the amount of the taxes due (Hansmann, 1989).

FEDERAL COURT RULINGS:

Not-for-profit organizations have challenged the IRS in Federal Court on many issues since Congress created the unrelated business income tax in Internal Revenue Code of 1950. The main issues that have come up in court cases concerning the unrelated business income tax deal with the three main points of the law: Is the income from trade or business, is the activity substantially related to the corporation tax-exempt

mission, and is the activity regularly carried on by the organization. Additionally, multiple cases have been heard in court dealing with the exceptions concerning royalties (any payment for the use of name), debt-financed property (property acquired through financing), unfair competition (competitive advantage that not-for-profit firms have by not paying taxes on income), and the bingo game exceptions (a bingo game operated by a not-for-profit may or may not be taxable, depending on the legality of the jurisdiction that the game is operated in).

Congress created the unrelated business income laws mainly in an effort to protect the tax base and prevent unfair competition. When Congress created the unrelated business income laws in 1950, "The underlying purpose was to help place both feeders and businesses operated directly by exempt organizations on a competitive basis with tax-paying rivals" (C.F. Mueller Co. v. Commissioner, 1951). Several organizations have tried to argue that even though they have income that meets the requirements to be taxed as unrelated business income, they are not subject to the tax because of the absence of a for-profit organization that is in competition with them. The IRS has always challenged this point and the courts support their opinion. The case commonly referenced when dealing with unfair competition is the Louisiana Credit Union League V. the United States of America from the United States Court of Appeals, 5th Circuit, in 1982. The Louisiana Credit Union argued that the court must look at the intent of Congress when ruling on the case. The appellate judge ruled that even though one of Congress's main goals was to prevent unfair competition, no where in the law does it say that unfair competition has to exist for a not-for-profit organization to be subject to the tax. The judge said, "Congress has for thirty years had the option of creating a requirement of

competition with taxable entities as a prerequisite for taxation on unrelated business income; it has not done so" (Louisiana Credit Union League v. United States, 1982). Therefore, the court ruled in favor of the IRS and the Louisiana Credit Union League had to pay the taxes owed.

The cases that have been argued in the federal courts concerning the trade or business portion of the law have for the most part dealt with the existence of a profit motive. The Portland Golf Club v. Commissioner of the Internal Revenue Service is the case commonly referenced in case proceedings dealing with a trade or business and the absence of a profit motive. This case was appealed to the United States Supreme Court who ruled in favor of the IRS. The Portland Golf Club was a members' club that had a substantial amount of investment gains that was subject to the unrelated business income tax. The golf club also had food sales to non-members of the club on which it was losing money. Portland Golf Club claimed that since these were not members and therefore not related to its exempt mission, then the loss on food sales to non-members fell under the unrelated business income tax and was deductible against the club's investment income. The IRS disagreed with this position on the basis that the food sales were not a business due to the lack of a profit motive. The court ruled that since food was being sold below the wholesale variable cost that the club was paying for the food, that the club had no intention of making a profit on the food. With the absence of a profit motive, the court ruled that the food sales was not a trade or business and therefore not subject to the unrelated business income tax laws. Since the food sales was ruled not a business, the court disallowed the deduction of the loss against investment income gains.

Another case that deals with the trade or business rules and has been referenced in several cases since is American Academy of Family Physicians v. the United States of America. In this case the IRS contended that since the organization was making a profit from insurance sales to member physicians, that this money was taxable subject to the unrelated business income tax. The court ruled "Contrary to the IRS's view, not every income-producing and profit-making endeavor constitutes a trade or business" (American Academy v. U.S., 1996). The court continues to say that it promotes the tax-exempt mission of the organizations to obtain discounted group insurance rates for its members. Since it promotes the tax-exempt mission of the organization, then it is not considered unrelated business income.

The next item commonly discussed in court cases is determining if the activity is substantially related to the not-for-profit organization's core mission for which it receives its tax-exemption. As noted in the law, funds cannot be the motivation for the activity for it to be considered substantially related. The item must have a causal relationship with the tax-exempt mission. This must be substantial in proportion to the effort required for the activity in order for it to be considered substantially related. A case law example of an item being substantially related is the case of St. Luke's Hospital of Kansas City v. the United States of America (1980). The questionable tax position in the case was whether St. Luke's providing pathology tests for area doctors constituted taxable income or if it was substantially related to St. Luke's tax-exempt mission. The portion of St. Luke's mission that applies in this case is teaching and training new doctors. To be able to properly train new doctors, the hospital needed to include positive cancer cells in their study. By conducting the tests for area doctors, the hospital also was able to collect

samples that it could use in the classroom to teach future doctors. The U.S. District Court ruled that by producing the needed samples, the hospital was promoting its exempt mission and therefore the service revenue received was not taxable.

The National Collegiate Athletic Association v. Commissioner of Internal Revenue Service court case from 1990 is considered a landmark case for unrelated business income tax law as written. It shows how much leeway there is in the tax law. This case shows that as long as an entity can argue their position they have a chance to win in court. The IRS claimed that the NCAA March Madness basketball tournament program was being operated as a regularly carried on business and was therefore subject to unrelated business taxes. The NCAA successfully argued that the program was only produced and marketed for a few weeks a year, whereas a similar for-profit entity like *Sports Illustrated* worked year round to produce their products.

The first major notable exception for the unrelated business income deals with royalties. Sierra Club, Inc., v. the Commissioner of the Internal Revenue Service is the regularly referenced case in concerning an activity being a royalty or an item subject to unrelated income is. The issue in the Sierra Club case deals with the use of Sierra Club's mailings list by a credit card company. Sierra Club argues that it is a royalty licensing agreement, while the IRS contends that the credit card marketing constitutes a regularly carried on business. The IRS challenged several companies on the credit card issue, including several university alumni associations from around the country.

The case uses the "Black's Law Dictionary … comprehensive definition of a royalty" for its basis in deciding on the issue (Appendix C) (Sierra Club v. Commissioner, 1996). The court ruled in favor of the Sierra Club stating that payment

for use of the mailing list and the Sierra Club name constitutes a royalty based on the Black's Law Dictionary and therefore the payments are not taxable as unrelated business income.

The next exception to the law that commonly comes up in court cases concerns debt-financed property. Section 514 of the tax code is entirely dedicated to dealing with debt-financed property and the unrelated business income. Section 514 states that any amount of money earned by property that is subject to debt financing is taxable as unrelated business income.

The last major issue that comes up in tax court cases deals with the bingo exception, as described in section 513 subsection "f" of the tax code. Section 513(f) states that profits from bingo games are not subject to the unrelated business income tax if the game is held in a geographic area where state law prevents for-profits firms from hosting bingo games. If the for-profit firms are allowed by law to hold bingo games, then the non-profit organizations are subject to the tax to prevent an unfair competitive advantage for the non-profit firm.

CONCLUSION:

There have been numerous cases argued in the court system dealing with the unrelated business income tax laws. Historically, not-for-profit firms have won most cases involving income from a source that is being contested on the basis of being "substantially related" to the firm's tax-exempt mission or the "regularly carried on" dealing with the amount of time the organization spent working on the activity. Not-for-profits had a fairly easy time in the courts proving that money was for a royalty payment and not a payment for services. The one item that not-for-profits lost its argument for

each time it was adjudicated in the courts was income received from property which was debt-financed. When items were contested in the courts on the basis of it being a "trade or business," the court is split in its decision between the not-for-profit entities and the Internal Revenue Service. If the not-for-profit entity can argue that no profit motive existed, then they avoided the taxes. Otherwise, the not-for-profits are usually losing the cases and are being taxed.

The landmark cases in not-for-profit accounting and unrelated business income tax laws are the C.F. Mueller v. Commissioner case that provoked the creation of the law in 1950 and the NCAA v. Commissioner case in 1990. The Mueller Macaroni case is commonly referenced because it was the first case and it was what the laws were written to prevent. The NCAA case is the case commonly referenced when dealing with an activity is regularly carried on and how much time is spent on an activity. The NCAA case is such a popular reference because it shows what a good lawyer can successfully argue. The NCAA case involved the program for the NCAA March Madness basketball tournament. The lawyers argued that the time spent on the program should be compared to the amount of time *Sports Illustrated* spent on producing each of its weekly magazines. Had the court compared the NCAA tournament to the NBA tournament, it is almost certain that the court would have ruled in favor of the IRS, and the NCAA would be paying more money in taxes.

The next major UBIT issue that will probably be decided is misallocation of deductions between unrelated taxable income sources and tax-exempt income sources. The IRS is currently studying reporting differences between the form 990's and form990T's. They have found that twenty percent of filed returns have expenses that are

misallocated between the forms (Arnsberger, Ludlum, & Riley, 2005). Of the returns with errors, seventy-nine percent were completed by paid tax preparers (Arnsberger, Ludlum, & Riley, 2005). "If IRS plans to use tax processing data to make intelligent decisions regarding regulation, compliance, or potential abuses of tax-exempt status, it is imperative that a high priority be placed on educating nonprofit organizations and their tax practitioners to report detailed items completely and accurately" (Arnsberger, Ludlum, & Riley, 2005).

APPENDIX A

Organizations Exempt under IRC section 501

IRC Section	Description of Organization	General Nature of Activities
501(c)(1)	Corporations organized under an Act of Congress	U.S. instrumentality
501(c)(2)	Title-holding corporations for exempt organizations	Holding title to property for exempt organizations
501(c)(3)	Religious, educational, charitable, scientific, or literary organizations; organizations that test for public safety. Also, organizations that prevent cruelty to children or animals, or foster national or international amateur sports competition	Activities of a nature implied by the description of the class of organization
501(c)(4)	Civic leagues, social welfare organizations, and local associations of employees	Promotion of community welfare and activities from which net earnings are devoted to charitable, educational, or recreational purposes
501(c)(5)	Labor, agricultural, and horticultural organizations	Educational or instructive groups whose purpose is to improve conditions of work, products, and efficiency
501(c)(6)	Business leagues, chambers of commerce, real estate boards, and like organizations	Improving conditions in one or more lines of business
501(c)(7)	Social and recreational clubs	Pleasure, recreation, and social activities
501(c)(8)	Fraternal beneficiary societies and associations	Lodges providing for payment of life, health, accident, or other insurance benefits to members
501(c)(9)	Voluntary employees' beneficiary associations (including Federal employees' voluntary beneficiary associations formerly covered by section 501(c)(10))	Providing for payment of life, health, accident, or other insurance benefits to members
501(c)(10)	Domestic fraternal beneficiary societies and associations	Lodges, societies, or associations devoting their net earnings to charitable, fraternal, and other specified purposes, without life, health, or accident insurance benefits to members
501(c)(11)	Teachers' retirement fund associations	Fiduciary associations providing for payment of retirement benefit
501(c)(12)	Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations	Activities of a mutually beneficial nature implied by the description of the class of organization
501(c)(13)	Cemetery companies	Arranging for burials and incidental related activities
501(c)(14)	State-chartered credit unions and mutual insurance or reserve funds	Providing loans to members or providing insurance of, or reserve funds for, shares or deposits in certain banks or loan associations
501(c)(15)	Mutual insurance companies or associations other than life, if written premiums for the year do not exceed $350,000	Providing insurance to members, substantially at cost

501(c)(16)	Corporations organized to finance crop operations	Financing crop operations in conjunction with activities of a marketing or purchasing association
501(c)(17)	Supplemental unemployment benefit trusts	Fiduciary agent for payment of supplemental unemployment compensation benefits
501(c)(18)	Employee-funded pension trusts (created before June 25, 1959)	Providing for payments of benefits under a pension plan funded by employees
501(c)(19)	Posts or organizations of past or present members of the armed forces	Providing services to veterans or their dependents; advocacy of veteran's issues; and promotion of patriotism and community service programs
501(c)(20)	REPEALED	
501(c)(21)	Black Lung Benefit Trusts	Providing funds to satisfy coal mine operators' liability for disability or death due to black lung disease
501(c)(22)	Withdrawal liability payment funds	Providing funds to meet the liability of employers withdrawing from a multiple-employer pension fund
501(c)(23)	Associations of past and present members of the armed forces founded before 1880	Providing insurance and other benefits to veterans or their dependents
501(c)(24)	Trusts described in section 4049 of the Employee Retirement Income Security Act of 1974	Providing funds for employee retirement income
501(c)(25)	Title-holding corporations or trusts with no more than 35 shareholders or beneficiaries and only one class of stock or beneficial interest	Acquiring real property and remitting all income earned from such property to one or more exempt organizations; pension, profit-sharing, or stock bonus plans; or governmental units
501(c)(26)	State-sponsored high-risk health insurance plans	Providing coverage for medical care on a not-for-profit basis to residents with pre-existing medical conditions that resulted in denied or exorbitantly priced traditional medical care coverage
501(c)(27)	State-sponsored workers' compensation reinsurance plans	Pooled employers' funds providing reimbursements to employees for losses arising under workers' compensation acts; also, State-created, -operated, and -controlled organizations providing workers' compensation insurance to employers

Source: (Arnsberger et al., 2008)

APPENDIX B

IRC §511: Imposition of tax on unrelated business income of charitable organizations

(a) Charitable, etc., organizations taxable at corporation rates

(1) Imposition of tax
There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) Organizations subject to tax

(A) Organizations described in sections 401 (a) and 501 (c)
The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501 (c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501 (a).

(B) State colleges and universities
The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or 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. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b) Tax on charitable, etc., trusts

(1) Imposition of tax
There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1 (e). In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.

(2) Charitable, etc., trusts subject to tax
The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501 (a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

(c) Special rule for section 501 (c)(2) corporations
If a corporation described in section 501 (c)(2)—

(1) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501 (a) (or which would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and

(2) such corporation and such organization file a consolidated return for the taxable year, such corporation shall be treated, for purposes of the tax imposed by subsection (a), as being organized and operated for the same purposes as such organization, in addition to the purposes described in section 501 (c)(2).

APPENDIX C

Black's Law Dictionary definition of a royalty:

Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment which is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an inventor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property.

Source: (Sierra Club v. Commissioner, 1996)

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