

section 501(a) is subject to the unrelated business income tax under section 511 and this section does not in any way enlarge the permissible scope of business activities of such class for purposes of the continued qualification of such class under section 501(a).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7183, 37 FR 7884, Apr. 21, 1972; T.D. 7632, 44 FR 42681, July 20, 1979]

§ 1.511-3 Provisions generally applicable to the tax on unrelated business income.

(a) *Assessment and collections.* Since the taxes imposed by section 511 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 511. Organizations subject to the tax imposed by section 511(a)(1) are subject to the same provisions, including penalties, as are provided in the case of the income tax of other corporations. In the case of a trust subject to the tax imposed by section 511(b)(1), the fiduciaries for such trust are subject to the same provisions, including penalties, as are applicable to fiduciaries in the case of the income tax of other trusts. See section 6151, *et seq.*, and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) *Returns.* For requirements of filing annual returns with respect to unrelated business taxable income by organizations subject to the tax on such income, see section 6012, paragraph (e) of § 1.6012-2, and paragraph (a)(5) of § 1.6012-3.

(c) *Taxable years, method of accounting, etc.* The taxable year (fiscal year or calendar year, as the case may be) of an organization shall be determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing unrelated business taxable income, the determination of the taxable year for which an item of income or expense is taken into account shall

be made under the provisions of sections 441, 446, 451, and 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon unrelated business taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 511, unless such method is changed in accordance with the provisions of § 1.166-1. A taxpayer which has not previously selected a method for treating bad debts may, in its first return under section 511, exercise the option granted in § 1.166-1.

(d) *Foreign tax credit.* See section 515 for provisions applicable to the credit for foreign taxes provided in section 901.

§ 1.511-4 Minimum tax for tax preferences.

The tax imposed by section 56 applies to an organization subject to tax under section 511 with respect to items of tax preference which enter into the computation of unrelated business taxable income. For this purpose, only those items of income and those deductions entering into the determination of the tax imposed by this section are considered in the determination of the items of tax preference under section 57. For rules relating to the minimum tax for tax preferences, see sections 56 through 58 and the regulations thereunder.

[T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§ 1.512(a)-1 Definition.

(a) *In general.* Except as otherwise provided in § 1.512(a)-3, § 1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines *unrelated business taxable income* as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in § 1.512(b)-1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not

only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be *directly connected with* the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see § 1.584-2(c)(3).

(b) *Expenses attributable solely to unrelated business activities.* Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Code, connected with the conduct of that activity and are deductible in computing unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167.

(c) *Dual use of facilities or personnel.* Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable

to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of \$20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of \$2,000 (10 percent of \$20,000), would be allowable for the salary paid to its president.

(d) *Exploitation of exempt activities—(1) In general.* In certain cases, gross income is derived from an unrelated trade or business activity which exploits an exempt activity. One example of such exploitation is the sale of advertising in a periodical of an exempt organization which contains editorial material related to the accomplishment of the organization's exempt purpose. Except as specified in subparagraph (2) of this paragraph and paragraph (f) of this section, in such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income. Since such items are incident to an activity which is carried on in furtherance of the exempt purpose of the organization, they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity.

(2) *Allowable deductions.* Where an unrelated trade or business activity is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of

such business, expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business activity to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the exempt activity; and

(ii) The allocation of such excess to the unrelated trade or business activity does not result in a loss from such unrelated trade or business activity.

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt activity must be allocated first to the exempt activity to the extent of the income derived from or attributable to the performance of that activity. Furthermore, such items are in no event allocable to the unrelated trade or business activity exploiting such exempt activity to the extent that their deduction would result in a loss carryover or carryback with respect to that trade or business activity. Similarly, they may not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity not exploiting the same exempt activity. See paragraph (f) of this section for the application of these rules to periodicals published by exempt organizations.

(e) *Examples.* This section is illustrated by the following examples:

Example 1. W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other advertising materials to its members, charging the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from an unrelated trade or business activity. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business, or allocable to such business under the rule of paragraph (c) of this section, are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used full-time in the unrelated business activity and

an allocable portion of the salaries of personnel used both to carry on exempt activities and to conduct the unrelated business activity. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business activity—W's membership—but are incurred primarily in connection with W's fundamental purpose as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business activity and do not qualify as directly connected with it.

Example 2. (i) P, a manufacturer of photographic equipment, underwrites a photography exhibition organized by M, an art museum described in section 501(c)(3). In return for a payment of \$100,000, M agrees that the exhibition catalog sold by M in connection with the exhibit will advertise P's product. The exhibition catalog will also include educational material, such as copies of photographs included in the exhibition, interviews with photographers, and an essay by the curator of M's department of photography. For purposes of this example, assume that none of the \$100,000 is a qualified sponsorship payment within the meaning of section 513(i) and § 1.513-4, that M's advertising activity is regularly carried on, and that the entire amount of the payment is unrelated business taxable income to M. Expenses directly connected with generating the unrelated business taxable income (i.e., direct advertising costs) total \$25,000. Expenses directly connected with the preparation and publication of the exhibition catalog (other than direct advertising costs) total \$110,000. M receives \$60,000 of gross revenue from sales of the exhibition catalog. Expenses directly connected with the conduct of the exhibition total \$500,000.

(ii) The computation of unrelated business taxable income is as follows:

(A) Unrelated trade or business (sale of advertising):		
Income	\$100,000
Directly-connected expenses	(25,000)
Subtotal	75,000	\$75,000
(B) Exempt function (publication of exhibition catalog):		
Income (from catalog sales)	60,000
Directly-connected expenses	(110,000)
Net exempt function income (loss)	(50,000)	(50,000)

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Unrelated business taxable income	25,000
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(iii) Expenses related to publication of the exhibition catalog exceed revenues by \$50,000. Because the unrelated business activity (the sale of advertising) exploits an exempt activity (the publication of the exhibition catalog), and because the publication of editorial material is an activity normally conducted by taxable entities that sell advertising, the net loss from the exempt publication activity is allowed as a deduction from unrelated business income under paragraph (d)(2) of this section. In contrast, the presentation of an exhibition is not an activity normally conducted by taxable entities engaged in advertising and publication activity for purposes of paragraph (d)(2) of this section. Consequently, the \$500,000 cost of presenting the exhibition is not directly connected with the conduct of the unrelated advertising activity and does not have a proximate and primary relationship to that activity. Accordingly, M has unrelated business taxable income of \$25,000.

(f) *Determination of unrelated business taxable income derived from sale of advertising in exempt organization periodicals*—(1) *In general.* Under section 513 (relating to the definition of unrelated trade or business) and §1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business activity involving the exploitation of an exempt activity; namely, the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical. Paragraph (d) of this section provides for the allowance of deductions attributable to the production and distribution of the readership content of the periodical. Thus, subject to the limitations of paragraph (d)(2) of this section, where the circulation and readership of an exempt organization periodical are utilized in connection with the sale of advertising in the periodical, expenses, depreciation, and similar items of deductions attributable to the production and distribution of the editorial or readership content of the periodical shall qualify as items of deductions directly connected with the unrelated advertising activity. Subparagraphs (2) through (6) of this paragraph provide rules for determining the amount of unrelated business taxable income attributable to the

sale of advertising in exempt organization periodicals. Subparagraph (7) of this paragraph provides rules for determining when the unrelated business taxable income of two or more exempt organization periodicals may be determined on a consolidated basis.

(2) *Computation of unrelated business taxable income attributable to sale of advertising*—(i) *Excess advertising costs.* If the direct advertising costs of an exempt organization periodical (determined under subparagraph (6)(ii) of this paragraph) exceed gross advertising income (determined under subparagraph (3)(ii) of this paragraph), such excess shall be allowable as a deduction in determining unrelated business taxable income from any unrelated trade or business activity carried on by the organization.

(ii) *Excess advertising income.* If the gross advertising income of an exempt organization periodical exceeds direct advertising costs, paragraph (d)(2) of this section provides that items of deduction attributable to the production and distribution of the readership content of an exempt organization periodical shall qualify as items of deduction directly connected with unrelated advertising activity in computing the amount of unrelated business taxable income derived from the advertising activity to the extent that such items exceed the income derived from or attributable to such production and distribution, but only to the extent that such items do not result in a loss from such advertising activity. Furthermore, such items of deduction shall not qualify as directly connected with such advertising activity to the extent that their deduction would result in a loss carryback or carryover with respect to such advertising activity. Similarly, such items of deduction shall not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity other than such advertising activity. Thus:

(a) If the circulation income of the periodical (determined under subparagraph (3)(iii) of this paragraph) equals or exceeds the readership costs of such

periodical (determined under subparagraph (6)(iii) of this paragraph), the unrelated business taxable income attributable to the periodical is the excess of the gross advertising income of the periodical over direct advertising costs; but

(b) If the readership costs of an exempt organization periodical exceed the circulation income of the periodical, the unrelated business taxable income is the excess, if any, of the total income attributable to the periodical (determined under subparagraph (3) of this paragraph) over the total periodical costs (as defined in subparagraph (6)(i) of this paragraph).

See subparagraph (7) of this paragraph for rules relating to the consolidation of two or more periodicals.

(iii) *Examples.* The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example 1. X, an exempt trade association, publishes a single periodical which carries advertising. During 1971, X realizes a total of \$40,000 from the sale of advertising in the periodical (gross advertising income) and \$60,000 from the sales of the periodical to members and nonmembers (circulation income). The total periodical costs are \$90,000 of which \$50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and \$40,000 is attributable to the production and distribution of the readership content (readership costs). Since the direct advertising costs of the periodical (\$50,000) exceed gross advertising income (\$40,000), pursuant to subdivision (i) of this subparagraph, the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

Gross advertising revenue	\$40,000
Direct advertising costs	(50,000)
	(10,000)
Loss attributable to advertising	(10,000)

X has realized a loss of \$10,000 from its advertising activity. This loss is an allowable deduction in computing X's unrelated business taxable income derived from any other unrelated trade or business activity.

Example 2. Assume the facts as stated in example 1, except that the circulation income of X periodical is \$100,000 instead of

\$60,000, and that of the total periodical costs, \$25,000 are direct advertising costs, and \$65,000 are readership costs. Since the circulation income (\$100,000) exceeds the total readership costs (\$65,000), pursuant to subdivision (ii)(a) of this subparagraph the unrelated business taxable income attributable to the advertising activity is \$15,000, the excess of gross advertising income (\$40,000) over direct advertising costs (\$25,000).

Example 3. Assume the facts as stated in example 1, except that of the total periodical costs, \$20,000 are direct advertising costs and \$70,000 are readership costs. Since the readership costs of the periodical (\$70,000), exceed the circulation income (\$60,000), pursuant to subdivision (ii)(b) of this subparagraph the unrelated business taxable income attributable to advertising is the excess of the total income attributable to the periodical over the total periodical costs. Thus, X has unrelated business taxable income attributable to the advertising activity of \$10,000 (\$100,000 total income attributable to the periodical less \$90,000 total periodical costs).

Example 4. Assume the facts as stated in example 1, except that the total periodical costs are \$120,000 of which \$30,000 are direct advertising costs and \$90,000 are readership costs. Since the readership costs of the periodical (\$90,000), exceed the circulation income (\$60,000), pursuant to subdivision (ii)(b) of this subparagraph the unrelated business taxable income attributable to advertising is the excess, if any, of the total income attributable to the periodical over the total periodical costs. Since the total income of the periodical (\$100,000) does not exceed the total periodical costs (\$120,000), X has not derived any unrelated business taxable income from the advertising activity. Further, only \$70,000 of the \$90,000 of readership costs may be deducted in computing unrelated business taxable income since as provided in subdivision (ii) of this subparagraph, such costs may be deducted, to the extent they exceed circulation income, only to the extent they do not result in a loss from the advertising activity. Thus, there is no loss from such activity, and no amount may be deducted on this account in computing X's unrelated trade or business income derived from any other unrelated trade or business activity.

(3) *Income attributable to exempt organization periodicals—(i) In general.* For purposes of this paragraph the total income attributable to an exempt organization periodical is the sum of its gross advertising income and its circulation income.

(ii) *Gross advertising income.* The term *gross advertising income* means all amounts derived from the unrelated advertising activities of an exempt organization periodical (or for purposes

of this paragraph in the case of a taxable organization, all amounts derived from the advertising activities of the taxable organization).

(iii) *Circulation income.* The term *circulation income* means the income attributable to the production, distribution or circulation of a periodical (other than gross advertising income) including all amounts realized from or attributable to the sale or distribution of the readership content of the periodical, such as amounts realized from charges made for reprinting or republishing articles and special items in the periodical and amounts realized from sales of back issues. Where the right to receive an exempt organization periodical is associated with membership or similar status in such organization for which dues, fees or other charges are received (hereinafter referred to as *membership receipts*), circulation income includes the portion of such membership receipts allocable to the periodical (hereinafter referred to as *allocable membership receipts*). Allocable membership receipts is the amount which would have been charged and paid if:

(a) The periodical was that of a taxable organization.

(b) The periodical was published for profit, and

(c) The member was an unrelated party dealing with the taxable organization at arm's length.

See subparagraph (4) of this paragraph for a discussion of the factors to be considered in determining allocable membership receipts of an exempt organization periodical under the standard described in the preceding sentence.

(4) *Allocable membership receipts.* The allocable membership receipts of an exempt organization periodical shall be determined in accordance with the following rules:

(i) *Subscription price charged to nonmembers.* If 20 percent or more of the total circulation of a periodical consist of sales to nonmembers, the subscription price charged to such nonmembers shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(ii) *Subscription price to nonmembers.* If paragraph (f)(4)(i) of this section does not apply and if the membership dues

from 20 percent or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(iii) *Pro rata allocation of membership receipts.* Since it may generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities (including the periodical) of the organization, the share of membership receipts allocated to the periodical, where paragraphs (f)(4) (i) and (ii) of this section do not apply, shall be an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization. For example, assume that an exempt organization has total periodical costs of \$30,000 and other exempt costs of \$70,000. Further assume that the membership receipts of the organization are \$60,000 and that paragraphs (f)(4) (i) and (ii) of this section do not apply. Under these circumstances \$18,000 ($\$60,000 \times \$30,000 / \$100,000$) is allocated to the periodical's circulation income.

(5) *Examples.* The rules set forth in paragraph (f)(4) of this section may be illustrated by the following examples. For purposes of these examples it is assumed that the exempt organization periodical contains advertising, and that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example 1. U is an exempt scientific organization with 10,000 members who pay annual dues of \$15 per year. One of U's activities is the publication of a monthly periodical which is distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmember subscribers at a cost of \$10 per year. Pursuant to paragraph (f)(4)(i) of this section, since the nonmember circulation of U's periodical represents 33⅓ percent of its total circulation the subscription price charged to nonmembers will be

used to determine the portion of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts will be \$100,000 (\$10 times 10,000 members), and U's total circulation income for the periodical will be \$150,000 (\$100,000 from members plus \$50,000 from sales to nonmembers).

Example 2. Assume the facts as stated in example 1, except that U sells only 500 copies of its periodical to nonmembers, at a price of \$10 per year. Assume further that U's members may elect not to receive the periodical, in which case their annual dues are reduced from \$15 per year to \$6 per year, and that only 3,000 members elect to receive the periodical and pay the full dues of \$15 per year. U's stated subscription price to members of \$9 consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represents only 14 percent of the 3,500 copies distributed, pursuant to paragraph (f)(4)(i) of this section, the \$10 subscription price charged to nonmembers will not be used in determining the portion of membership receipts allocable to the periodical. On the other hand, since 70 percent of the members elect not to receive the periodical and pay \$9 less per year in dues, pursuant to paragraph (f)(4)(ii) of this section, such \$9 price will be used in determining the subscription price charged to members. Thus, the allocable membership receipts will be \$9 per member, or \$27,000 (\$9 times 3,000 copies) and U's total circulation income will be \$32,000 (\$27,000 plus \$5,000).

Example 3. (a) W, an exempt trade association, has 800 members who pay annual dues of \$50 per year. W publishes a monthly journal the editorial content and advertising of which are directed to the business interests of its own members. The journal is distributed to all of W's members and no receipts are derived from nonmembers.

(b) W has total receipts of \$100,000 of which \$40,000 (\$50×800) are membership receipts and \$60,000 are gross advertising income. W's total costs for the journal and other exempt activities is \$100,000. W has total periodical costs of \$76,000 of which \$41,000 are direct advertising costs and \$35,000 are readership costs.

(c) Paragraph (f)(4)(i) of this section will not apply since no copies are available to nonmembers. Therefore, the allocation of membership receipts shall be made in accordance with paragraph (f)(4)(iii) of this section. Based upon pro rata allocation of membership receipts (40,000) by a fraction the numerator of which is total periodical costs (\$76,000) and the denominator of which is the total costs of the journal and the other exempt activities (\$100,000), \$30,400 (\$76,000/\$100,000 times \$40,000) of membership receipts is circulation income.

(6) *Deductions attributable to exempt organization periodicals—(i) In general.* For purposes of this paragraph the term *total periodical costs* means the total deductions attributable to the periodical. For purposes of this paragraph the total periodical costs of an exempt organization periodical are the sum of the direct advertising costs of the periodical (determined under subdivision (ii) of this subparagraph) and the readership costs of the periodical (determined under subdivision (iii) of this subparagraph). Items of deduction properly attributable to exempt activities other than the publication of an exempt organization periodical may not be allocated to such periodical. Where items are attributable both to an exempt organization periodical and to other activities of an exempt organization, the allocation of such items must be made on a reasonable basis which fairly reflects the portion of such item properly attributable to each such activity. The method of allocation will vary with the nature of the item, but once adopted, a reasonable method of allocation with respect to an item must be used consistently. Thus, for example, salaries may generally be allocated among various activities on the basis of the time devoted to each activity; occupancy costs such as rent, heat and electricity may be allocated on the basis of the portion of space devoted to each activity; and depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity. Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations.

(ii) *Direct advertising costs.* (a) The direct advertising costs of an exempt organization periodical include all expenses, depreciation, and similar items of deduction which are directly connected with the sale and publication of advertising as determined in accordance with paragraphs (a), (b), and (c) of this section. These items are allowable as deductions in the computation of unrelated business income of the organization for the taxable year to the extent they meet the requirements of

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section 162, section 167, or other relevant provisions of the Code. The items allowable as deductions under this subdivision do not include any items of deduction attributable to the production or distribution of the readership content of the periodical.

(b) The items allowable as deductions under this subdivision would include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and direct office overhead directly connected with the sale of advertising lineage in the periodical. Also included would be other items of deduction commonly classified as advertising costs under standard account classification, such as art work and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

(c) In addition to the items of deduction normally included in standard account classifications relating to advertising costs, it is also necessary to ascertain the portion of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includible in mechanical and distribution costs ordinarily employed in business-paper and consumer publication accounting provide a guide for the computation. Thus, the mechanical and distribution costs in such cases would include the portion of the costs and other expenses of composition, presswork, binding, mailing (including paper and wrappers used for mailing), and the bulk postage attributable to the advertising lineage of the publication. The portion of mechanical and distribution costs attributable to advertising lineage of the periodical will be determined on the basis of the ratio of advertising lineage to total lineage of the periodical, and the application of that ratio to the total mechanical and distribution costs of the periodical, where records are not kept in such a manner as to reflect more accurately the allocation of mechanical and distribution costs to advertising lineage of the periodical, and where there is no factor in the character of the periodical to indicate that such an allocation would be unreasonable.

(iii) *Readership costs.* The *readership costs* of an exempt organization periodical include expenses, depreciation or similar items which are directly connected with the production and distribution of the readership content of the periodical and which would otherwise be allowable as deductions in determining unrelated business taxable income under section 512 and the regulations thereunder if such production and distribution constituted an unrelated trade or business activity. Thus, readership costs include all the items of deduction attributable to an exempt organization periodical which are not allocated to direct advertising costs under subdivision (ii) of this subparagraph, including the portion of such items attributable to the readership content of the periodical, as opposed to the advertising content, and the portion of mechanical and distribution costs which is not attributable to advertising lineage in the periodical.

(7) *Consolidation*—(i) *In general.* Where an exempt organization subject to unrelated business income tax under section 511 publishes two or more periodicals for the production of income, it may treat the gross income from all (but not less than all) of such periodicals and the items of deduction directly connected with such periodicals (including readership costs of such periodicals), on a consolidated basis as if such periodicals were one periodical in determining the amount of unrelated business taxable income derived from the sale of advertising in such periodical. Such treatment must, however, be followed consistently and once adopted shall be binding unless the consent of the Commissioner is obtained as provided in sections 446(e) and § 1.446-1(e).

(ii) *Production of income.* For purposes of this subparagraph, an exempt organization periodical is *published for the production of income* if:

(a) The organization generally receives gross advertising income from the periodical equal to at least 25 percent of the readership costs of such periodical, and

(b) The publication of such periodical is an activity engaged in for profit.

For purposes of the preceding sentence, the determination whether the publication of a periodical is an activity engaged in for profit is to be made by reference to objective standards taking into account all the facts and circumstances involved in each case. The facts and circumstances must indicate that the organization carries on the activity with the objective that the publication of the periodical will result in economic profit (without regard to tax consequences), although not necessarily in a particular year. Thus, an exempt organization periodical may be treated as having been published with such an objective even though in a particular year its total periodical costs exceed its total income. Similarly, if an exempt organization begins publishing a new periodical, the fact that the total periodical costs exceed the total income for the startup years because of a lack of advertising sales does not mean that the periodical was published without an objective of economic profit. The organization may establish that the activity was carried on with such an objective. This might be established by showing, for example, that there is a reasonable expectation that the total income, by reason of an increase in advertising sales, will exceed costs within a reasonable time. See § 1.183-2 for additional factors bearing on this determination.

(iii) *Example.* This subparagraph may be illustrated by the following example:

Example. Y, an exempt trade association, publishes three periodicals which it distributes to its members: a weekly newsletter, a monthly magazine, and quarterly journal. Both the monthly magazine and the quarterly journal contain advertising which accounts for gross advertising income equal to more than 25 percent of their respective readership costs. Similarly, the total income attributable to each such periodical has exceeded the total deductions attributable to each such periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price is not intended to cover the cost of publication. The newsletter is a service of Y distributed to all of its members in an effort to keep them informed of changes occurring in the business world and is not engaged in for profit. Under these circumstances, Y may consolidate the income and deductions from the monthly and quar-

terly journals in computing its unrelated business taxable income, but may not consolidate the income and deductions attributable to the publication of the newsletter with the income and deductions of its other periodicals since the newsletter is not published for the production of income.

(g) *Foreign organizations—(1) In general.* The unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of:

(i) The organization's unrelated business taxable income which is derived from sources within the United States but which is not effectively connected with the conduct of a trade or business within the United States, plus

(ii) The organization's unrelated business taxable income effectively connected with the conduct of a trade or business within the United States (whether or not such income is derived from sources within the United States).

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see part 1, subchapter N, chapter 1 of the Code (section 861 and following) and the regulations thereunder.

(2) *Effective dates.* Subparagraph (1) of this paragraph applies to taxable years beginning after December 31, 1969. For taxable years beginning on or before December 31, 1969, the unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of the organization's unrelated business taxable income which:

(i) For taxable years beginning after December 31, 1966, is effectively connected with the conduct of a trade or business within the United States, whether or not such income is derived from sources within the United States;

(ii) For taxable years beginning on or before December 31, 1966, is derived from sources within the United States.

(h) *Effective date.* Paragraphs (a) through (f) of this section are applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated therein for taxable years

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beginning before December 13, 1967, he may do so.

[T.D. 7392, 40 FR 58638, Dec. 18, 1975, as amended by T.D. 7438, 41 FR 44392, Oct. 8, 1976; T.D. 7935, 49 FR 1694, Jan. 13, 1984; T.D. 8991, 67 FR 20437, Apr. 25, 2002]

§ 1.512(a)-2 Definition applicable to taxable years beginning before December 13, 1967.

(a) *In general.* The unrelated business taxable income which is subject to the tax imposed by section 511 is the gross income, derived by any organization to which section 511 applies, from any unrelated trade or business regularly carried on by it, less the deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions, and limitations referred to below. In the case of an organization which regularly carries on two or more unrelated businesses, its unrelated business taxable income is the aggregate of its gross income from all such unrelated businesses, less the aggregate of the deductions allowed with respect to all such unrelated businesses. For provisions generally applicable to the unrelated business tax, see § 1.511-3, and for rules applicable to the determination of the adjusted basis of property, see paragraph (a)(2) of § 1.514(a)-1.

(b) *Effective date.* Except as provided in paragraph (f) of § 1.512(a)-1, this section is applicable with respect to taxable years beginning before December 13, 1967.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17660, Dec. 12, 1967]

§ 1.512(a)-3 [Reserved]

§ 1.512(a)-4 Special rules applicable to war veterans organizations.

(a) *In general.* For taxable years beginning after December 31, 1969, this section provides special rules for the determination of the unrelated business taxable income of an organization described in section 501(c)(19). In general, the rules contained in sections 511 through 514 which are applicable to any organization listed in section 501(c) apply in determining the unrelated business taxable income of an organiza-

tion described in section 501(c)(19). However, that amount which is paid by members to the organization for the purpose described in paragraph (b)(1) of this section, if set aside from other organizational monies and accounts in an insurance set aside, may be excluded from the unrelated business taxable income of the organization. The insurance set aside shall be used exclusively for providing insurance benefits, for the purposes specified in section 170(c)(4) of the Code, for the reasonable costs of administering the insurance program that are directly related to such set aside, or for the reasonable costs of distributing funds for section 170(c)(4) purposes. If an amount so set aside is used for any purposes other than those described in the preceding sentence, it shall be included in unrelated business taxable income without regard to any modifications provided by section 512(b), in the taxable year in which it is withdrawn from such set aside. Amounts will be considered to have been withdrawn from an insurance set aside if they are used in any manner inconsistent with providing insurance benefits, paying the reasonable costs of administering the insurance program for section 170(c)(4) purposes and for costs of distributing funds for section 170(c)(4) purposes. An example of a use of funds which would be considered a withdrawal would be the use of such funds as security for a loan.

(b) *Insurance set aside—(1) Purpose of payments by members.* Payments by members (including commissions on such payments earned by the set aside as agent for an insurance company) into an insurance set aside must be for the sole purpose of obtaining life, sick, accident or health insurance benefits from the organization or for the reasonable costs of administration of the insurance program, except that such purpose is not violated when excess funds from an experience gain are utilized for those purposes specified in section 170(c)(4) or the reasonable costs of distributing funds for such purposes. Funds for any other purpose may not be set aside in the insurance set aside.

(2) *Income from set aside.* In addition to the payments by members described in paragraph (b)(1) of this section, only income from amounts in the insurance