U. MUSEUM RETAILING - UBIT ISSUES

Introduction

The traditional museum sales desk that sold post cards and guide books, has, in recent years, become a full-scale retail operation offering a wide array of goods ranging from expensive reproductions of fine art treasures to freeze-dried Neapolitan-flavor astronaut ice cream. Such offerings to the museum patron seem to be limited only by the museum retailers' imagination. Today museums are living more and more off the marketing of their merchandise. As an example, according to Time (December 18, 1978), New York City's Metropolitan Museum of Art for 1977 grossed slightly under $16.8 million for its merchandising, no less than 44 percent of its gross income of $37.8 million. In their search for funds to meet the rise of utilities and payrolls, many museums have resorted to commercial exploitation, as we are currently witnessing with the King Tut road show, and are moving increasingly into the retail area with their stores, mail order catalogs and tie-ins with local retail outlets. See The Art Museum: Power, Money, Ethics, by Karl E. Meyer, Twentieth Century Fund, Morrow, New York (1979). The recently published The Second Shopper's Guide to Museum Stores, compiled by Shelley Hodupp (1978), provides a concise, illustrated and informative review of the ever-expanding range of museum products from some 143 United States museums, art centers, libraries, historical societies and restoration villages.

The discussion here will center on issues concerning museum gift shop and catalog retailing along with museum restaurant sales and parking lots; specifically, those involving whether such activities are unrelated trades or businesses and thus subject to the unrelated business income tax.

Travel tour activities, an ever increasing retail activity of many exempt organizations, including museums, are discussed in this 1979 EOATRI textbook at page 453.

For discussion of other topics of some relatedness and application to museum retailing see the following in this EOATRI textbook:

Advertising Regulations at page 533;
Royalties and Exploitation Income at page 521; and
Recent Developments Under UBIT Provisions at page 443.

1. Background

Prior to enactment of the Revenue Act of 1950 (which added IRC provisions now numbered 502 and 511 through 514), the Service made numerous attempts to deny exemption to organizations which engaged in transparently profit-making activities on the ground that these organizations were not organized and operated exclusively for their stated exempt purpose. The courts almost always ruled against the Government in these proceedings, however. The principal stumbling block was the "destination of income" test laid down by the United States Supreme Court in Trinidad v. Sagrada Orden de Predicadores, 263 US 578, T.D. 3548, III-1 C.B. 270 (1924), holding, at least in common understanding, that the destination and not the source of the income was the ultimate test of the right of exemption.

Also, prior to 1951, certain organizations popularly called "feeder" organizations were held exempt from Federal income tax under the predecessor to IRC 501(c)(3), even though their sole activity was engaging in commercial business, and the only basis for exemption was the fact their profits were payable to specified exempt organizations. See Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (1938); Willingham v. Home Oil Mill, 181 F.2d 9 (1950); C.F. Mueller Company V. Commissioner, 190 F.2d 120 (1951). The courts held that the exclusive purpose required by the exemption statute was met when the only object of the organization was religious, scientific, charitable, or educational, without regard to the method of obtaining funds necessary to effectuate the objective. Under this rationale, C.F. Mueller Company which, as its sole activity, operated a commercial macaroni factory and turned the profits over to its exempt parent, was held exempt from Federal income tax as an exclusively charitable organization.

Congress dealt with these situations by enacting the unrelated trade or business tax provisions and a provision to prevent the exemption of "feeder" organizations in the Revenue Act of 1950, which among other things, was designed to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. For a more extensive discussion of these provisions, see Chapters 32, 35, 36 and 37 of the EOHB (IRM 7751).

Under the Tax Reform Act of 1969, IRC 513(c) was amended to include what will be referred to as the "fragmentation" rule. By application of this rule, the unrelated parts of a trade or business can be separated from the related and taxed. The fragmentation rule was first promulgated in the IRC 513 regulations for

taxable years beginning after 1967, but may be of limited applicability for years prior to 1970.

2. Law and Regulations

a. General

IRC 511(a) imposes a tax upon the unrelated business taxable income (as defined in IRC 512) of organizations exempt from Federal income tax under IRC 501(c)(3). IRC 512(a) defines "unrelated business taxable income" as income from any "unrelated trade or business" regularly carried on by the organization as computed in the manner provided in IRC 512.

The term "unrelated trade or business" is defined in IRC 513(a) as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other exempt purposes.

b. Special Exceptions

IRC 513(a)(1), (a)(2) and (a)(3) provide exceptions to unrelated trade or business activities. IRC 513(a)(1) and (a)(3) and Regs. 1.513-2(b) provide that certain activities are not unrelated if substantially all of the work is carried on by uncompensated volunteers or if substantially all of the merchandise sold is received as gifts or donations. IRC 513(a)(2) and Regs. 1.513-2(b) provide that the trade or business activities carried on by certain exempt organizations will not be unrelated if carried on primarily for the convenience of the organization's members, students, patients, officers or employees.

c. Trade or Business

Regs. 1.513-1(b) states that the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of IRC 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in

competition with taxable organizations. However, in general, any activity of an IRC 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of IRC 162 - and which, in addition, is not substantially related to the performance of exempt functions - presents sufficient likelihood of unfair competition to be within the policy of the tax.

d. Substantially Related

Regs. 1.513-1(d)(1) provides that gross income derives from "unrelated trade or business" within the meaning of IRC 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question - the activities, that is, of producing or distributing the goods or performing the services involved - and the accomplishment of the organization's exempt purposes.

e. Type of Relatedness Required

Regs. 1.513-1(d)(2) provides that a trade or business is "related" to exempt purposes only where the conduct of the business has causal relationship to the achievement of the exempt purposes, and it is "substantially related" for purposes of IRC 513 only if the causal relationship is a substantial one. Therefore, for the conduct of a trade or business to be substantially related to such purposes, the activity of the trade or business itself must contribute importantly to the accomplishment of those purposes.

f. Size and Extent of Activities

Regs. 1.513-1(d)(3) states that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Therefore, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business.

g. Dual Use of Assets of Facilities

Regs. 1.513-1(d)(4)(iii) provides that in certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under IRC 501(c)(3) has a theater auditorium which is specially designed and equipped for showing of educational films in connection with its program of public education in the Arts and Sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

h. The "Trinket" Rule

Regs. 1.513-1(b) provides that the sending out of low cost articles incidental to fund raising activities are not subject to UBIT. The rule is also found in c. above in its full exposition.

i. The "Fragmentation" Rule

IRC 513(c) states that for purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

IRC 513(c) and Regs. 1.513-1(b) delineate the scope of a "trade or business," stating that for purposes of IRC 513 the term "trade or business" has the same meaning it has in IRC 162, and that such activity can be unrelated even though it exists within the framework of a larger commercial operation that

constitutes a related business. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as a trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes. This principle is illustrated in Rev. Rul. 68-374, 1968-2 C.B. 242.

The text of Rev. Rul. 68-374 is extracted below:

Circumstances in which an exempt hospital derives unrelated business taxable income from the sale of pharmaceutical supplies to the general public.

Advice has been requested as to the circumstances in which the sale of pharmaceutical supplies to the general public by the pharmacy of a hospital, exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, results in unrelated business taxable income under section 512 of the Code.

Section 513 of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profit derived) to the exercise or performance by such organization of its exempt functions.

To the extent relevant here, section 513(a)(2) of the Code further states that the term "unrelated trade or business" does not include any trade or business which is carried on by an organization described in section 501(c)(3) primarily for the convenience of its patients.

Section 512 of the Code defines the term "unrelated business taxable income" as the income as computed in this section derived by organizations from any unrelated trade or business regularly carried on.

Section 1.513-1(c)(1) of the Income Tax Regulations states that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on" within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(c)(2)(ii) of the regulations states that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations. In general, exempt organization businesses which are engaged in only discontinuously or periodically will not be considered regularly carried on if they

are conducted without the competitive and promotional efforts typical of commercial endeavors.

Section 1.513-1(c)(2)(ii) of the regulations further states that where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions "primarily for the convenience" of such persons within the meaning of section 513(a)(2), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

The application of the principles and requirements set forth in the above sections of the Code and regulations to sales by a hospital pharmacy to members of the general public is illustrated in the two situations set out below.

Situation 1. A hospital exempt from Federal income tax under section 501(c)(3) of the Code maintains a facility on the ground floor of its main building for the sale of pharmaceutical supplies. In addition to prescription drugs, the pharmacy also sells nonprescription drugs and a few personal articles. The primary source of the pharmacy's income is sales to patients of the hospital. See Revenue Ruling 68-376, page 246, of this Bulletin, for illustrative descriptions of persons considered "patients" of a hospital. However, the pharmacy is also open to the general public. A small percentage of its income is from frequent and continuous sales of prescription and nonprescription drugs to persons who are not patients of the hospital, but who walk in off the streets to make purchases from the pharmacy.

The buyer-seller relationship between these off-street patrons and the hospital pharmacy is not, in and of itself, sufficient to classify such persons as "patients" of the hospital. Therefore, sales to these persons cannot be considered primarily for the convenience of the patients of the hospital within the meaning of section 513(a)(2) of the Code.

Furthermore, there is no substantial causal relationship between the achievement of the hospital's exempt purposes and the sale of pharmaceutical supplies to members of the general public who do not otherwise avail themselves of the hospital's medical or diagnostic facilities. Therefore, this sales activity constitutes the conduct of unrelated trade or business within the meaning of section 513 of the Code.

The hospital pharmacy's facilities are freely available to patients and nonpatients alike. Pharmaceutical sales to the general public are frequent and continuous and are thus regularly carried on within the meaning of section 512 of the Code.

Accordingly, the income derived by the hospital from the sale of pharmaceutical supplies to the general public constitutes "unrelated business taxable income" as defined in section 512 of the Code.

Situation 2. A hospital exempt from Federal income tax under section 501(c)(3) of the Code maintains a limited number of consultation and examination rooms that are available to its medical staff for treating their private patients. These rooms are used only when it is mutually convenient for the patient and physician to meet at the hospital. Patients visiting their physicians in these rooms are not patients of the hospital. If, during the course of such visits, the patient receives a prescription from his physician, he may fill it at any pharmacy.

The hospital maintains a pharmacy for the use of its own patients. Sales to non-patients are not ordinarily permitted. However, as a courtesy to its medical staff, the pharmacy will occasionally fill prescriptions written by the physicians for their private patients, but such sales are not promoted by the hospital, do not occur with frequency, and represent only an insignificant portion of the pharmacy's total sales.

Under these circumstances, such sales would constitute unrelated trade or business as defined in section 513, since they are neither primarily for the convenience of the hospital's patients within the meaning of section 513(a)(2) nor substantially related to the exercise or performance of the hospital's exempt purposes. However, in view of the manner in which they are conducted, these nonqualifying sales are considered casual sales within the meaning of section 1.513-1(c)(2)(ii) of the regulations. Income derived from such sales does not constitute income derived from unrelated trade or business that is regularly carried on and, therefore, does not constitute "unrelated business taxable income" within the meaning of section 512 of the Code.

Similar to the pharmaceutical sale activities in Rev. Rul. 68-374, activities of soliciting, selling and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. The particular purpose behind the enactment of IRC 513(c) and the previously promulgated Regs. 1.513-1(b) was, of course, to "fragment" out the advertising portion of the periodical, otherwise editorially related, for purposes of unrelated trade or business liabilities.

The use of this "fragmentation" rule, is particularly applicable to museum retailing. In museum shops, although some items sold may be substantially related to the educational goal of the museum, others my not. Through use of the

fragmentation rule, the Service can separate out the related sales from the unrelated.

3. Museum Revenue Rulings

The landmark Revenue Rulings in the museum retailing area are Rev. Ruls. 73-104, 73-105, 74-399 and 69-629.

a. Rev. Rul. 73-104, 1973-1 C.B. 263

The sale by an exempt art museum, including sales through a mail order catalog, of greeting cards that display printed reproductions of selected art works from the museum's collection and from other art collections does not constitute unrelated trade or business as their sale "contributes importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest and appreciation of art. Moreover, a broader segment of the public may be encouraged to visit the museum itself to share in its educational functions and programs as a result of seeing the cards."

The text of Rev. Rul. 73-104 is extracted below:

> **The sale of greeting card reproductions of art works by an art museum exempt from tax under section 501(c)(3) of the Code does not constitute unrelated trade or business.**
>
> **Rev. Rul. 73-104**
>
> Advice has been requested whether, under the circumstances described below, the sales activities of an educational organization that is exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 constitutes unrelated trade or business within the meaning of section 513 of the Code.
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> The organization maintains and operates an art museum devoted to the exhibition of modern art. The museum offers for sale to the general public greeting cards that display printed reproductions of selected works from the museum's collection and from other art collections. The proportions of the reproductions are determined by the form of the original work and care is taken with respect to other technical aspects of the reproduction process. Each card is imprinted with the name of the artist, the title or subject matter of the work, the date or period of its creation, if known, and the museum's name. The cards contain appropriate greetings and are personalized on request.

The organization sells the cards in the shop it operates in the museum. It also publishes a catalogue in which it solicits mail orders for the greeting cards. The catalogue is available at a small charge and is advertised in magazines and other publications throughout the year. In addition, the shop sells the cards at quantity discounts to retail stores. As a result, a large volume of cards are sold at a significant profit.

Section 511(a) of the Code imposes a tax upon the unrelated business taxable income (as defined in section 512) of organizations exempt from Federal income tax under section 501(c)(3). Section 512(a) of the Code defines "unrelated business taxable income" as income from any "unrelated trade or business" regularly carried on by the organization as computed in the manner provided in section 512.

The term "unrelated trade or business" is defined in section 513 of the Code as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Section 513(c) of the Code and section 1.513-1(b) of the Income Tax Regulations provide that trade or business includes any activity which is carried on for the production of income from the sale of goods.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "substantially related" to purposes for which exemption is granted only if the production or distribution of the goods from which the gross income is derived "contributes importantly" to the accomplishment of those purposes.

The museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of works of art. The sale of greeting cards displaying printed reproductions of art works contributes importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art. Moreover, a broader segment of the public may be encouraged to visit the museum itself to share in its educational functions and programs as a result of seeing the cards. The fact that the cards are promoted and sold in a clearly commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact of the activity's relatedness to the museum's exempt purpose.

Accordingly, it is held that these sales activities do not constitute unrelated trade or business under section 513 of the Code.

b. Rev. Rul. 73-105, 1973-1 C.B. 264

An exempt museum of American folk art offers for sale in its shop or through catalog sales four categories of items: (1) reproductions of art works from the museum's collection and from other art collections which take the form of prints suitable for framing, postcards, greeting cards and slides; (2) metal, wood and ceramic copies of American folk art objects from its collection and other collections; (3) instructional literature concerning the history and development of art, particularly folk art; and (4) scientific books and various souvenir items relating to the city in which the museum is located. Items (1), (2) and (3) contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby enhancing the public's understanding and appreciation of art. Item (4), however, consists of objects that have no causal relationship to art or to artistic endeavor and do not contribute importantly to the accomplishments of the museum's exempt purpose and, therefore, their sale constitutes an unrelated trade or business. Note also, incidentally, that Rev. Rul. 73-105, adds to the list of conceivably related sales (and rentals), slides, metal, wood and ceramic copies of art works, and instructional literature concerning the history and development of art. Rev. Rul. 73-104 concerned itself only with the sale of greeting cards that display printed reproductions of art.

The text of Rev. Rul. 73-105 is extracted below:

The sale of scientific books and city souvenirs by a museum of folk art exempt from tax under section 501(c)(3) of the Code constitutes unrelated trade or business even though other items sold in the museum shop are related to its exempt function.

Rev. Rul. 73-105

Advice has been requested whether, under the circumstances described below, the sales activities of an art museum exempt from Federal income tax as an educational organization under section 501(c)(3) of the Internal Revenue Code of 1954 constitute unrelated trade or business within the meaning of section 513 of the Code.

The organization maintains and operates an art museum devoted to the exhibition of American folk art. It operates a shop in the museum that offers for sale to the general public: (1) reproductions of works in the museum's own collection and reproductions of artistic works from the collections of other art museums (these reproductions take the form of prints suitable for framing, postcards, greeting cards, and slides); (2) metal, wood, and ceramic copies of American folk art objects from its own collection and similar copies of art objects from other collections of art works; and (3) instructional literature concerning the

history and development of art and, in particular, of American folk art. The shop also rents originals or reproductions of paintings contained in its collection. All of its reproductions are imprinted with the name of the artist, the title or subject matter of the work from which it is reproduced, and the museum's name.

Also sold in the shop are scientific books and various souvenir items relating to the city in which the museum is located.

Section 511(a) of the Code imposes a tax upon the unrelated business taxable income (as defined in section 512) of organizations exempt from Federal income tax under section 501(c)(3). Section 512(a) of the Code defines "unrelated business taxable income" as the gross income from any "unrelated trade or business" regularly carried on by the organization as computed in the manner provided in section 512.

The term "unrelated trade or business" is defined in section 513 of the Code as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt functions.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that trade or business is "substantially related" to purposes for which exemption is granted only if the production or distribution of the goods from which the gross income is derived "contributes importantly" to the accomplishment of those purposes.

Section 513(c) of the Code and section 1.513-1(b) of the regulations provide that trade or business includes any activity which is carried on for the production of income from the sale of goods. An activity does not lose its identity as trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may not be related to the exempt purposes of the organization.

Thus, sales of a particular line of merchandise may be considered separately to determine their relatedness to the exempt purpose. Section 1.513-1(d)(2) of the regulations emphasizes that it is the particular facts and circumstances involved in each case which determines whether the activities in question contribute importantly to the accomplishment of any purpose for which the organization is exempt.

An art museum is exempt as an educational organization on the basis of its ownership, maintenance, and exhibition for public viewing of an art collection. The sale and rental of reproductions of works from the museum's own collection and reproductions of artistic works not owned by the museum contribute importantly to the achievement of the museum's exempt educational purpose by making works of art familiar to a broader segment of the public, thereby

enhancing the public's understanding and appreciation of art. The same is true with respect to literature relating to art.

Accordingly, it is held that these sales activities do not constitute unrelated trade or business under section 513 of the Code.

On the other hand, scientific books and souvenir items relating to the city where the museum is located have no causal relationship to art or to artistic endeavor and, therefore, the sale of these items does not contribute importantly to the accomplishments of the subject organization's exempt educational purpose which, as an art museum, is to enhance the public's understanding and appreciation of art. The fact that some of these items could, in a different context, be held related to the exempt educational purpose of some other exempt educational organization does not change the conclusion that in this context they do not contribute to the accomplishment of this organization's exempt educational purpose.

Additionally, under the provisions of section 513(c) of the Code, the activity with respect to sales of such items does not lose identity as trade or business merely because the museum also sells articles which do contribute importantly to the accomplishment of its exempt function.

Accordingly, it is held that the sale of those articles having no relationship to American folk art or to art generally, constitutes unrelated trade or business under section 513 of the Code.

c. Rev. Rul. 74-399, 1974-2 C.B. 172

The operation of a dining room, cafeteria, and snack bar by an exempt art museum for use by the museum staff, employees, and members of the public visiting the museum does not constitute an unrelated trade or business activity.

The eating facilities are commensurate with accommodations for those patrons. Facilities are accessible from the museum's galleries and not the street. Patronage is not directly or indirectly solicited nor are the facilities contemplated or designed to serve as a public restaurant. Profits, if any, are dedicated to exempt purposes.

The operation of the eating facilities within the museum premises helps to attract visitors to the museum exhibits. Because there are places of refreshment in the museum, visitors are able to devote a greater portion of their time and attention to the museum's collection, exhibits and other educational facilities than would be the case if they had to interrupt or terminate their tours to seek outside eating

facilities. The eating facilities also enhance the efficient operation of the entire museum by enabling the museum staff and employees to remain on its premises throughout the workday. Thus, the museum's operation of the eating facilities is a service that contributes importantly to the accomplishment of its exempt purposes.

The text of Rev. Rul. 74-399 is extracted below:

Unrelated income; museum operating dining room, cafeteria, and snack bar. The operation of a dining room, cafeteria, and snack bar by an exempt art museum for use by the museum staff, employees, and members of the public visiting the museum does not constitute an unrelated trade or business activity.

Rev. Rul. 74-399

The Internal Revenue Service has been asked whether the operation of eating facilities by a museum in the manner described below is unrelated trade or business within the meaning of section 513 of the Internal Revenue Code of 1954.

The organization, exempt under section 501(c)(3) of the Code, is organized and operated as an art museum. Its facilities include a dining room, cafeteria, and snack bar. The eating facilities are open to the museum staff, employees, and members of the public visiting the museum and are of a size commensurate with accommodation of these special groups of patrons. The facilities are accessible from the museum's galleries and other public areas but not directly accessible from the street. The patronage of the eating facilities by the general public is not directly or indirectly solicited nor are the facilities contemplated or designed to serve as a public restaurant but merely to serve the exempt purposes of the museum. Profits, if any, are dedicated to the furtherance of the purposes for which the museum is organized and operated.

Section 513 of the Code defines "unrelated trade or business" as any trade or business, the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt functions.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "substantially related" only if the production or distribution of the goods or the performance of the services from which the gross income is derived contributes importantly to the accomplishment of the purposes for which exemption was granted.

In Rev. Rul. 69-268, 1969-1 C.B. 160, a hospital operated a cafeteria and coffee shop that was open to persons visiting hospital patients. The operation of the eating facilities was held not unrelated trade or business within the meaning of section 513 of the Code. Visits by outsiders are regarded as a form of supportive

therapy that assists in the recovery of patients. The hospital's permitting outside visitors to use its eating facilities enabled the visitors to spend more time with the patients and thus contributed importantly to the hospital's exempt purpose.

In the case at hand, the operation of the eating facilities within the museum premises helps to attract visitors to the museum exhibits. Because there are places of refreshment in the museum visitors are able to devote a greater portion of their time and attention to the museum's collection, exhibits and other educational facilities than would be the case if they had to interrupt or terminate their tours of the museum to seek outside eating facilities at mealtime. The eating facilities also enhance the efficient operation of the entire museum by enabling the museum staff and employees to remain on its premises throughout the workday. Thus, the museum's operation of the eating facilities is a service that contributes importantly to the accomplishment of its exempt purposes.

Accordingly, the operation of the eating facilities by the museum under the particular circumstances is substantially related to the museum's exempt purposes and consequently is not unrelated trade or business within the meaning of section 513 of the Code.

d. Rev. Rul. 69-269, 1969-1 C.B. 160

The operation of an adjacent parking lot by an exempt hospital otherwise lacking sufficient parking space for the use of its patients and visitors contributes importantly to the hospital's exempt purpose by encouraging visitation of patients which constitutes supportive therapy that assists in patient treatment and encourages their recovery. Any profits from the fee charged for the use of the lot is placed in the hospital's general operating fund. Therefore, providing such parking facilities does not constitute unrelated trade or business.

Although Rev. Rul. 69-269 describes a hospital parking lot, analogy would find equal application to a museum parking lot. Instead of for patients, of course, the lot would be for the benefit of museum visitors (and perhaps employees). Encouragement to museum visitation, of course, is provided through convenient parking. The reasoning here is thus also similar to that of the museum cafeteria Rev. Rul. 74-399, supra.

The text of Rev. Rul. 69-269 is extracted below:

The operation of a parking lot for patients and visitors only by a section 501(c)(3) hospital does not constitute unrelated trade or business under section 513 of the Code.

Rev. Rul. 69-269

Advice has been requested whether, under the circumstances described below, the operation of a parking lot by a hospital exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 is unrelated trade or business within the meaning of section 513 of the Code.

The hospital was concerned with providing sufficient parking space for visitors because visitation is considered to be supportive therapy and part of patient treatment. Because of a serious lack of adequate parking space, the hospital constructed adjacent to its main building a parking lot for patients and visitors only. The lot is not for general public utilization. A fee is charged for the use of these facilities and all profits are placed in the hospital's general operating fund.

Section 513 of the Code defines the term "unrelated trade or business" as any trade or business, the conduct of which is not substantially related (aside from the need of an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its exempt functions.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is "substantially related" only if the production or distribution of the goods or the performance of the services from which the gross income is derived contributes importantly to the accomplishment of the purposes for which exemption was granted.

One of the purposes of the hospital is to provide health care for members of the community. Visitation of patients constitutes supportive therapy that assists in patient treatment and encourages their recovery. Without adequate parking facilities for patients and visitors, the hospital could not operate with maximum effectiveness in serving the public. See Ellis Hospital v. Fredette, 279 NYS 2d 925 (1967). Therefore, it is held that providing such facilities contributes importantly to the accomplishment of the hospital's exempt purpose. Accordingly, this activity is substantially related to the purpose constituting the basis for the hospital's exemption and does not constitute unrelated trade or business within the meaning of section 513 of the Code.

4. UBIT Application

a. General

Most museums qualify as organizations organized and operated exclusively for charitable and educational purposes under IRC 501(c)(3). Regs. 1.501(c)(3)-1(d)(3)(ii) specifically lists a museum as an example of an educational

organization. Generally under IRC 513, gift shops and their mail order catalogs, traditionally associated with museums, contribute importantly to the exempt purpose of museums and thus provide substantially related activity; assuming, of course, that such vehicles primarily promote wares related to museums' educational functions.

The convenience exception of IRC 513(a)(2) would not likely apply to museum gift shops, cafeterias or parking lots except for certain sales made to the museum's members, officers or employees. It may be questioned, however, whether the membership convenience exception is ever applicable to museums whose variety of wares sometimes equal that of a department store. Commonly, members receive a gift shop discount-right as a benefit of membership. The uncompensated volunteers or donated merchandise exceptions of IRC 513(a)(1) and (a)(3) could be applicable, of course, if facts so indicate, but are not generally typical with the large or medium-size American museum.

The American Association of Museums has defined the purpose of a museum as the conservation and preservation, study, interpretation, enhancement, and in particular the organization and enjoyment of objects and specimens of educational and cultural value, including artistic, scientific, historical and technological material. This is a broad definition, and presumably a museum organized and operated for such broad purposes could sell and distribute a relatively wide range of educational items without becoming subject to unrelated business income tax. There are broadly eclectic museums - ones that perhaps cover all of man's artistic, historical, and natural interests. There are also many museums which have a narrower focus of concentration, such as a modern art museum that concentrates on 19th and 20th century American and European paintings and sculpture.

It would be reasonable to conclude that more items of merchandise could be regarded as substantially related to the exempt function of a eclectic museum than would be the case with a modern art museum.

b. Museum Sales -- The Related and the Unrelated

One of the most active areas of concern deals with whether individual items sold within museum gift shops and mail order catalogs are substantially related.

Rev. Rul. 73-105, supra, suggests two categories of items that may be admittedly educational but have no causal relationship to the exempt function and

purpose of an art museum: first, items which are in no way related to art (e.g., mineral specimens and science books); and second, items that are so trivial or have such a remote connection with the promotion of art that their causal relationship to the museum's exempt purpose cannot be demonstrated (e.g., novelty items and souvenirs).

This does not mean, however, that an art museum which concentrates on a certain period or school of art would be prohibited from selling books or reproductions of other artistic periods or art movements at the risk that such sales would be unrelated. In fact, Rev. Rul. 73-105 would suggest the opposite. The basis for the exemption of any art museum is that it is an organization devoted to the advancement of art by increasing public interest in art knowledge and appreciation. No period or school of art is independent of all others. Consequently, there is likely a causal relationship between reproductions of artistic work from outside collections representing other periods and instructional literature concerning the general history and development of art and any museum's particular art concentration.

Museum Rev. Ruls. 73-104 and 73-105 are rather specific in the listing of related sales of art reproductions. They are greeting cards, slides, metal, wood and ceramic copies of art works and instructional literature. Other common items sold in museums include clothing, jewelry, etc., as well as popular notions and novelties.

Items of clothing may generally be classified as a necessity, a luxury or a novelty while jewelry may be classified as a luxury or a novelty. Representative examples of such items could be a T-shirt with an imprint of Old Master subjects, scarves and ties with the pattern of tiles of the ancient world, earrings and bracelets with symbols of ancient Egypt and coin necklaces and money clips with images of ancient Greece. It does not seem to be within the exempt function of any museum to provide clothing, nor can it be said that luxuries are within the purview of a museum's exempt function. The sale of such items by a museum could therefore be viewed as unrelated trade or business.

As another example, consider a museum's exhibit on timepieces. Would this justify the characterization of a sale of brand-name watches in the museum's store or catalog as substantially related? It is doubtful that a causal relationship could exist between the sale of the watches and the educational function of the exhibit anymore than an maritime museum could demonstrate causal relationship in the sale of power boats.

Likewise, the sale of such items as aprons, tote bags, needlecraft kits, pillows and wearing apparel by a textile museum should be considered unrelated until substantial relatedness can be clearly established.

c. Reproductions and Adaptions (or Adaptations)

When we come to the area of reproductions and adaptions the facts of each museum's particular situation must be examined carefully. Faithful reproductions of the museum's art and artifacts could be considered to be related items. The term "reproduction," however, should have a narrow meaning pursuant to Rev. Ruls. 73-104 and 73-105. It should be applied perhaps only to items (e.g., wood, metal or ceramic) which are copies of pieces originally created by master period craftsmen and are made today in a manner commensurate with the period.

There would be a strong argument presented to hold that a reproduced item of Colonial American furniture is substantially related to the exempt purpose of a museum concentrating on 18th century Americana if that item were faithfully recreated in the Colonial manner. The utilitarian aspect of a museum piece reproduction should not be determinative for substantial relatedness. The reproductions sold by the folk art museum in Rev. Rul. 73-105, supra, included metal, wood and ceramic copies of American folk art objects. Presumably, these reproductions included objects with a utilitarian quality (e.g., wooden or ceramic bowls, vases, etc.). In any event, many items of museum furniture, such as those found in many of the American museum collections, are classified as great art works or historically significant. It would be difficult to distinguish sales of reproductions of such furniture items by a museum concentrating in 18th century Americana, for example, from sales of reproductions of Old Master paintings or photographs of a Picasso.

The above discussion should not mean, of course, that a museum can sell a complete line of home furnishings and escape UBIT liabilities. Issues should immediately be raised, for example, over sales of such items as draperies, bedspreads, sheets, towels and linens, as well as sales of any items that are not reproductions of actual items in the museum's collection or in other museum collections.

"Adaptions" should raise issues. In the context of unrelated trade or business, an adaption could be defined as an item in which the element of art

reproduction is insignificant and an incidental aspect, the sale of which would not contribute importantly to the museum's educational purposes.

What makes an item an "adaption" rather than a "reproduction" is a question that must be considered. The Webster's Third New International Dictionary, unabridged (1961) defines "adapt" as, "To make suitable for a new and different use or situation by means of changes or modifications...in form or structure." Based on this definition, "adaptions" could cover a very broad area and may include such items as a polymer resin copy of a Japanese woodcarving, a ceramic two inch high replica of a Ming vase, a stationery and desk set imprinted with a Chinese flower scene, a silk scarf patterned after the back of a ceremonial chair, a trash basket decorated with the Spirit of '76, a 14 carat gold jewelry pendant representing the sphinx, and a baby's T-shirt imprinted with the Mona Lisa.

It would have to be said that the nexus to substantial relatedness becomes rather thin in sales of many of these items from even the most liberal analysis of IRC 513.

The issues discussed above are worth raising in individual cases.

d. Unrelated Items Affixed with Logos

Many low-cost items sold by museums and traveling collections have affixed a museum logo for commemorative or promotional value to enhance public awareness and encourage visitations.

Valuable utilitarian items such as umbrellas and tote bags may also be sold with the logo. Note that in this context the utilitarian nature of items may be determinative. These items are not reproductions of museum pieces. Regs. 1.513-1(b) states that sales of low cost articles or trinkets incidental to fund raising are not subject to UBIT. If we analogize here, however, such articles as umbrellas and tote bags are not low-cost articles. The fact that the museum's logo is affixed to them shouldn't have that much bearing on questions of relatedness. Substantial items such as director's chairs, barbecue aprons, ties, and pewter blazer buttons can cost anywhere from $10 to $50 or more and could well be considered items in the competitive marketplace.

A museum also may receive income from sales of reproduction items bearing its logo through a licensing agreement with a manufacturer who sells such

items through commercial retail outlets such as department stores. The following sub-topic discusses this issue.

e. Licensing Operations

Many museums receive licensing fees from various manufacturers which the museum licenses to produce reproductions and adaptions of articles in the museum's collection. The fees may be based on the number of articles produced by the manufacturers. The manufacturers market their products through various authorized retail outlets around the country.

The museums may subject the licensees to strict supervision to ensure the reproductions and adaptions are properly constructed. The museum generally may do extensive research on the reproduced article and it may make such research available to the licensees. The licensees are permitted to use the museum's authorized seal (or logo) on the articles they manufacturer. The museum has the right to inspect and determine whether the licensees are adequately carrying out the terms of the licensing agreements. In addition, the museum may contribute to a cooperative advertising and development fund.

Although the licensing operation is unrelated trade or business, the income would be most likely excludable from unrelated business taxable income by IRC 512(b)(2) through reason of the royalty income modification. See related topic in this area at page 531 of this EOATRI textbook and Private Ruling Letter 7841001 for an illustration.

f. Parking Lots and Restaurants

(1) Parking Lots

John H. Myers and Robert H. Myers, Jr., point out in their article, "How Art-Oriented Exempt Organizations can Skirt the Unrelated Business Income Tax" in The Journal of Taxation (September 1978), that "The existence of adequate parking facilities is of great importance to an organization which presents art to the public and enables it to carry out its exempt purpose. In the hospital context, the Service has ruled in Rev. Rul. 69-269 [supra], that the operation of a parking lot is a related business." However, as Messrs. Meyers' point out, a "museum or art facility must be careful of the danger of permitting a 'dual use' of its parking facility by encouraging (or allowing) individuals unrelated to the museum to park for a fee."

This situation, like that specified in Regs. 1.513-1(d)(4)(iii), where a museum theater is also utilized for public entertainment, are common situations that present museum administrators with "dual use" situations.

(2) Restaurants

It should be noted that the rationale of Rev. Rul. 74-399, supra, would not likely condone the operation of an expensive French restaurant in a museum as an activity substantially related to the museum's exempt educational purpose. The operation of such a restaurant would be beyond that necessary to adequately serve the museum's purpose.

However, the operation of a restaurant in a restored historical town complex, perhaps in the setting of an actual period tavern, furnished with the furniture of the period and serving food of the period, may likely be considered substantially related to the museum town's educational purpose. Dining in the restaurant could be considered a continuation of the learning experience which the museum town has to offer. But, the operation of that same restaurant outside of the town complex, accessible to the general public, as opposed to museum visitors, would not likely be held a substantially related activity.

5. Excessive Commercialization -- Future Considerations?

Rev. Rul. 73-104, supra, states expressly that the fact that greeting cards are promoted and sold in a clearly commercial manner at a profit and in competition with commercial greeting card publishers does not alter the fact of the activity's relatedness to the museum's exempt purpose. It may be questioned whether this Revenue Ruling will always continue to be on point in light of the growing commercial manner of promoting, producing and distributing museum merchandise that has occurred over the last few years. New publication (and perhaps new legislation) may be needed in this area.

There are presently no published precedents establishing limits on the size or scope of a substantially related business that an exempt organization may carry on, except the limitation suggested in Regs. 1.513-1(d)(3) with respect to activities that are conducted on a scale larger than is reasonably necessary for performance of an organization's exempt function. That limitation has yet to be defined. However, with the growing commercialization of some museums via mail order sale catalogs, separate museum shops in downtown business districts and suburban

shopping malls, there may some day be limits established, especially when facts indicate that the primary source of a museum's income is derived from retailing.

The factual situation of the museum shop that is located in a building detached from the museum it supposedly serves, such as rented space downtown or in suburbia or through arrangements with local retail stores, may be analogized with the dining facilities described in Rev. Rul. 74-399, supra. Those facilities were of a size commensurate with accommodations of the patrons, accessible from the museum's galleries and other public areas but not directly accessible from the street; the patronage of the eating facilities by the general public was not directly or indirectly solicited, nor were the facilities contemplated or designed to serve as a public restaurant but merely to serve the exempt purposes of the museum. Can as much be said about the separate museum shops?

For possible analogy, consider Rev. Rul. 67-4, 1967-1 C.B. 121, which states that an organization which engages in publishing scientific and medical literature may be exempt under IRC 501(c)(3) if it meets four specific conditions. Those conditions concern the content, preparation and distribution of the publication and provide that:

(1) the content of the publication be educational;

(2) the preparation of material follow methods generally accepted as "educational" in character;

(3) the distribution of the materials be necessary or valuable in achieving the organization's educational and scientific purposes; and

(4) the manner in which the distribution is accomplished be distinguishable from ordinary commercial publishing practices.

Although Rev. Rul. 67-4 concerns publication activities in an exemption context rather than in the UBIT context, consider application of the conditions to museum sales:

(1) the items, at least in appearance, must be substantially related;

(2) the items, or reproductions, are prepared in the manner of the period the art works or artifacts represent;

(3) the distribution of the items are provided to a reasonable segment of the public are sold only through the museum, and promote the museum's purpose of promoting art, history, science, etc., and

(4) distribution is distinguishable from ordinary commercial practices in that the charges cover only a portion of the cost.

This analysis, utilizing the Rev. Rul. 67-4 conditions, may not be entirely appropriate under existing guidelines, but should be worth consideration.

The text of Rev. Rul. 67-4 is extracted below:

Rev. Rul. 67-4

26 CFR 1.501(c)(3)-1: Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes or for the prevention of cruelty to children or animals.

An organization was formed for the purpose of encouraging basic research in specific types of physical and mental disorders, to improve educational procedures for teaching those afflicted with such disorders, and to disseminate educational information about such disorders, by the publication of a journal containing current technical literature relating to these disorders. The organization may qualify for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 if it meets prescribed conditions.

Revenue Ruling 60-351, C.B. 1960-2, 169, distinguished.

Advice has been requested whether a nonprofit organization formed and operated as described below qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The organization was formed to encourage scientific research in, and to disseminate educational information about, specific types of physical and mental disorders. This is accomplished by publishing a journal which contains abstracts of current information from the world's medical and scientific publications. The journal is sold, below cost, to the public.

The organization's staff consists of leading pathologists, other medical specialists, and teachers, most of whom donate their services. The organization receives income from the sale of subscriptions, contributions, and government grants. Its operating deficits are defrayed by contributions.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, educational, and scientific purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations defines the term "charitable" as used in section 501(c)(3) of the Code as including the advancement of education or science.

Revenue Ruling 66-147, C.B. 1966-1, 137, holds that the publication of abstracts of scientific and medical articles by an organization contributes to the advancement of education and science by providing an effective means for the increased dissemination and application of such knowledge.

An organization engaged in publishing scientific and medical literature may qualify for exemption from Federal income tax under section 501(c)(3) of the Code if (1) the content of the publication is educational, (2) the preparation of material follows methods generally accepted as "educational" in character, (3) the distribution of the materials is necessary or valuable in achieving the organization's educational and scientific purposes, and (4) the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.

The methods used in preparing and presenting the abstracts conform to methods traditionally accepted as "educational" in character. The organization provides a reference to literature on the research undertaken in the area, and enables the afflicted to receive improved instruction and treatment. The distribution of the abstracts is carried out essentially in a "charitable" manner, in the sense that there is a public benefit derived from the distribution. The charges for the publication recover only a portion of the costs.

Accordingly, the organization qualifies for exemption from Federal income tax under section 501(c)(3) of the Code.

An organization which considers itself within the scope of this Revenue Ruling must, in order to establish exemption under section 501(c)(3) of the Code, file an application on Form 1023, Exemption Application, with the District Director of Internal Revenue for the internal revenue district in which is located the principal place of business or the principal office of the organization. See section 1.501(a)-1 of the regulations.

This case is distinguishable from that in Revenue Ruling 60-351, C.B. 1960-2, 169, involving an organization which is publishing a magazine and selling it to the general public in accordance with ordinary commercial publishing practices.

6. Conclusion

There are many unresolved questions in this area and each individual case should be considered on its own facts and circumstances. The National Office will consider publication when cases warrant.