ADLER & COLVIN
A Law Corporation

135 MAIN STREET - 20TH FLOOR - SAN FRANCISCO, CALIFORNIA 94105
TEL: (415) 421-7555 - WWW.ADLERCOLVIN.COM

Periodical Income and Expenses

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The IRS usually takes the position that the activity of publishing advertisements, or even acknowledgments that have been paid and bargained for, in a periodical is not an activity that is substantially related to a charity's exempt purpose. The income from advertisements in a periodical is, therefore, generally subject to unrelated trade or business income tax ("UBIT").

The Regulations under Section 512 of the Internal Revenue Code ("IRC"), however, provide a fairly generous system of allocating expenses against such advertising income. This summary describes how those cost allocation rules operate. Charities and other tax-exempt organizations are strongly advised, however, to work with their bookkeepers and accountants to develop appropriate cost tracking and allocation systems.

Identify income and expenses. The first step is to identify the following items of income and expense:

- Advertising income — generally gross income from the sale of advertisements.
- Direct advertising costs — items of deduction which are directly connected with the sale and publication of advertising, following normal deduction principles under IRC Section 162.
- Circulation income — income from the sale of the publication and in some cases, described below, a portion of a member's membership contribution that is properly allocated to the member's right to receive the periodical.
- Readership costs — generally the costs of producing and distributing the periodical (other than advertising costs).

Calculate unrelated business income tax owed. The second step is to engage in a series of calculations:

- If direct advertising costs exceed advertising income, then there is a net loss from advertising. We need look no further, and the net loss is reported on the 990-T and can be applied against income from other trades or businesses of the same charity.
- If direct advertising costs are less than advertising income (i.e., there is a net profit from advertising), then we determine whether total periodical income (advertising income + circulation income) is greater or less than total periodical expenses (direct advertising costs + readership costs). If total expenses exceed income, then there is no net income, but we report a zero on the 990-T. The net loss, taking into account readership costs, cannot be used to offset the income from other UBIT activities.
- If direct advertising costs are less than advertising income (i.e., there is a net profit from advertising) but total periodical income exceeds total periodical expense, then we have some UBIT to report, but we still report the *lower of* the net profit from advertising or net profit from the entire periodical (which includes advertising and circulation).

The third scenario is the most typical — the tax-exempt organization realizes a profit from advertising and a loss from circulation. The circulation loss is used to offset some of the advertising profits to reduce the UBIT.

Special rules. Finally, there are some special rules.

- There are special rules for consolidating multiple periodicals of the same entity, which are beyond the scope of this summary.

- There are also special rules for determining when a portion of a membership contribution needs to be treated as circulation income. The IRS, for these purposes, seems to define members as individuals or organizations who have some voting power in the organization. In that case the following rules apply:

  1) If at least 20 percent of the total circulation of a periodical consists of sales to nonmembers, then the members are deemed to have paid the same amount as nonmembers for the periodical. So if a nonmember pays $20 for the periodical, then $20 of each member's dues is treated as circulation income. The Regulations discuss the definition of "member" for these purposes.

  2) If less than 20 percent of the total circulation income is attributable to nonmembers, but at least 20 percent of the members pay lower dues because they choose not to receive the periodical, then the amount of the reduction in dues determines the amount of circulation income from the members who pay full dues.

  3) If neither (1) nor (2) applies, then membership receipts are allocated to the periodical according to the ratio of the periodical costs to the organization's total costs. As an example, if a tax-exempt organization has $100,000 in membership dues, $50,000 in circulation income to nonmembers, total organizational expenses of $1 million, including total expenses for the periodical of $100,000, the circulation income equals the $50,000 from nonmembers, plus $100,000 in membership dues multiplied by the fraction $^{1}/_{10}$ ($100,000 in periodical expenses over $1 million in total expenses). Total circulation income is $60,000.

Although it is not entirely clear, we generally infer from the Regulations that if a periodical is not sold at all, to anyone, there is no circulation income, even from members.