

in the law

tax-exempt museums should beware of taxable activities

by H. Jacob Lager, Esq.

Museum retail sales have come a long way from the tiny booths that sold little more than post cards and guidebooks to museum visitors. Today's museums boast vast retail and sales operations -- from restaurants to diverse gift shop and catalog merchandise -- that both enhance patrons' experiences and boost the museum's bottom line.

But tax-exempt museums must be aware of activities that may be subject to unrelated business income tax ("UBIT"). When the museum engages in an activity that is not related to the tax-exempt purpose of the organization, it may have to pay tax on the "unrelated business income" ("UBI") from those activities. Too much UBI can jeopardize a museum's tax-exempt status. A more common problem occurs, however, when the IRS categorizes the museum's fundraising activity as UBI, thereby decreasing that revenue, sometimes significantly.

The IRS defines an unrelated business activity as having three elements: 1) the activity must be a trade or business; 2) the organization must regularly carry on the activity; and 3) the activity is not substantially related to furthering the exempt purpose of the organization. That third element is the most critical to the UBIT analysis. The IRS has ruled that an activity is substantially related to the exempt purpose if it "contributes importantly" to the museum's mission, which is generally to educate the public. The analysis does not turn on whether the proceeds from the activity are used to further the museum's exempt purpose, but whether the activity itself

contributes to the museum's accomplishment of its exempt purpose.

The following examples demonstrate the kinds of common museum activity that may be subject to UBIT:

- Restaurants: The IRS has ruled that an exempt art museum's operation of a dining room, cafeteria or snack bar contribute importantly to the museum's exempt purpose because such facilities help attract visitors to the exhibits and allow visitors to spend more time viewing the exhibits than they would if they had to leave the museum to eat. The facilities also improve efficient museum operation by enabling staff to remain on-site through the day. However, the specific facts make a difference. If the restaurant is accessible through a door directly to the street (not just through the museum), if restaurant patrons do not have to pay museum admittance fees, and/or if the restaurant is open to the public far beyond normal museum operating hours, the IRS may determine that the restaurant exists not merely for the convenience of the museum patrons and staff, but for general public use, and therefore its operations may be subject to UBIT.
- Reproductions and Gifts: An exempt art museum's sale of reproductions of museum pieces contributes importantly to the museum's purpose. The same is true for gifts that include reproductions

or artistic designs based on the museum's collections, such as books, greeting cards, neckties, playing cards, etc. To ensure exempt status, the item should be accompanied by descriptive literature highlighting the artistic, cultural, historical, or educational link between the item and the museum's exempt purpose. However, the sale of branded products, such as coffee mugs branded with the museum logo, city souvenirs, and other gifts that lack a connection to a museum art collection are generally subject to UBIT.

- Dual Facility Use: When a museum rents out its facilities for a use unrelated to its purpose, the income from that use is likely subject to UBIT. For example, if the facility is rented to an outside organization for an after hours cocktail party, gala event, or awards ceremony, any income resulting from this use will likely be treated as UBI, even if an exhibit, tour or educational component is included as a secondary element of the event. On the other hand, if the museum creates an after-hours educational program for an outside organization that focuses on an exhibit, lecture or tour related to the museum's purpose, that activity would likely be exempt, even if food and other services are provided as well.

If you are unclear about how the IRS might characterize an activity at your museum, you should consult with an experienced tax attorney. **ipm**

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