

## Unrelated Business Income Tax (UBIT)

### Introduction

Generally, organizations exempt from income tax under section 501(a) of the tax code do not pay federal income tax on their excess support and revenue over expenses (e.g. profits). However, Internal Revenue Code (IRC) Section 511 does impose a tax on the revenue generating activities of the otherwise exempt entity that are unrelated to their exempt purpose. *A common misconception of many nonprofits is that if the revenue generated from activities is used for exempt purposes then the means by which the revenue was generated is exempt as well and no tax is applicable.*

### Taxable Activities

IRC section 512 defines unrelated business taxable income (UBIT) as ... “*income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption (from income tax).*” In addition, the activity must exhibit all three of the following characteristics in order for the income to be considered taxable to the organization. It must be:

- Not substantially related to the purpose(s) for which tax exemption was granted by the IRS,
- A trade or business, and
- Regularly carried on.

There are numerous exceptions of course, with most being based upon the exact nature of the activity. But generally, where an exception occurs it means no tax is due and no return is required to be filed.

### The Concept of “Not Substantially Related”

IRC section 513 essentially defines “unrelated” as “...not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.”

Therefore, how an organization utilized any funds raised from an activity is of little importance in determining whether or not the activity is subject to UBIT. Rather, it is the nature of the activity itself that determines whether the funds generated are taxable. Accordingly, it is critical in deciding whether the activity is subject to UBIT to understand the exact purpose for which the organization was formed, as well as the purpose(s) encompassed by the subsection of IRC section 501(c) under which the organization qualifies.

#### *Example:*

A homeless shelter that raised additional funds for its programs by having a bake sale would be involved in an unrelated activity. The fact that the proceeds from the bake sale are used to pay to

shelter the homeless will not negate the fact that selling baked goods is not substantially related to the organization's exempt purpose.

There remain several other opportunities for this bake sale to be nontaxable, such as the regularity of the event, or the utilization of one of the exceptions to UBIT. However, it is important to note that the first attribute of the 3-part test would indicate that the bake sale may be taxable to the homeless shelter.

### *Causal Relationship*

Several important factors may enter into the determination of whether an activity is substantially related to an organization's exempt purpose. The first is these is there must be substantial causal relationship between the activity and the accomplishment of one of the organization's exempt purposes. A causal relationship occurs when it can be demonstrated that the activity contributes importantly to the accomplishment of a purpose for which the organization was granted an exemption. Simply raising funds to be used for the organization's exempt purpose would not qualify, you must demonstrate causal relationship. Examples include:

- Tuition revenue received by an educational organization in exchange for educational programs provided to students,
- Dues received by a trade association in exchange for industry-wide promotion,
- Admission fees received by a performing arts organization in exchange for a performance.

### *Size and Extent of the Activity*

A second factor that should be considered is the size and extent of the activity. Essentially what this relates to is conducting activity on a scale that goes beyond meeting the organizations own needs.

Example:

A 501(c)(3) Christian education organization formed a printing division to write and publish Christian textbooks for its students, with surplus books sold to other Christian schools. The printing division later expanded to the point that approximately 600,000 elementary and secondary school students were now using the organization's publications. Eventually, the gross revenues from the publishing division exceed 50% of the organization's total receipts. The IRS concluded that the "size and extent" of this publishing activity was far greater than what was needed to educate the organization's students. The result, all publishing income became subject to UBIT.

### *Type of Customers and Context of Sale*

The IRS has been known in certain situations to consider the type of customers and the context of the sale in determining whether income is substantially related to the accomplishment of an exempt purpose. For example, a monastery that made and sold caskets was found to generate UBIT when the caskets were made available to individuals who were not associated with the monastery or the denomination. In another case, the IRS considered the UBIT implications of income from the operation of a golf course, tennis courts, and boating facilities by a section 501(c)(3) organization formed to "promote the intellectual, social, physical, moral, and religious welfare of the people." In

this circumstance when the organization began to make its facilities available to “non-students,” income generated from those activities was subject to UBIT and only revenues generated for students who participated in the organization’s nine-week summer session was exempt.

### **The Concept of “Trade or Business”**

An activity will be considered as a trade or business if it is conducted to produce income from the sale of goods or performance of services. An additional and more difficult factor associated with this concept is the existence of a profit motive. Where an activity is engaged in for the purposes of making a profit, it will be considered a trade or business. This does not mean that the activity must make a profit. Only that it was entered into with the intention of making a profit.

Competition with commercial entities is at the core of the unrelated business income tax. However, it should be noted that even in the absence of unfair competition may not completely protect the activity from UBIT. In *LaBelle Post No. 217 v. United States* (580 F.2d 270, 272 (8<sup>th</sup> Cir. 1978)), operation of a bingo game was ruled to be unrelated trade or business activity by the court. In its conclusion, the court noted that the “tax on unrelated business income is not limited to income earned by a trade or business that operates in competition with taxpaying entities.”

### **The Concept of “Regularly Carried On”**

In determining whether an activity is regularly carried on, the frequency and continuity with which the activity is conducted must be assessed. Basically, if the frequency and continuity of the activity is similar to comparable commercial activities of nonexempt organizations, the activity will be considered to be regularly carried on.

The bake sale example held for the homeless shelter? If it is only carried on once a year (or even three or four times a year), it would not likely be considered regularly carried on, since most nonexempt bakeries are operated with much more frequency and continuity throughout the year. Conversely, where an exempt organization typically carries on an activity on a seasonal or periodic basis, it may be much easier to have that activity classed as “regularly carried on” and thus subject to UBIT.

Recently, the IRS has even begun taking into consideration the concept of *preparatory time* leading up to the carrying on of the activity in making its determination, although the issue has been considered in UBIT cases for many years (Rev Rul. 73-124). The IRS feels that the frequency of the event does not provide a complete picture as to the regularity of the activity. Such issues as time spent soliciting advertisements must be considered in determining whether advertising in an annual yearbook (for example) is regularly carried on.

The most notable case in this area to date involves the National Collegiate Athletic Association (NCAA). This case involved advertising included in the program book for the NCAA’s annual men’s basketball tournament. Although the program was distributed for only about three weeks, the IRS felt that the significant preparatory time leading up to the tournament caused the activity to be regularly carried out. In a decision that the IRS strongly disagrees with, the final court decision was in favor of the NCAA, when they concluded that preparatory time is not a factor and that the regularity of the activity itself should be the only consideration.

## **The “Fragmentation” Rule**

Finally, there is what is called the fragmentation rule. IRC section 513(c) and section 1.513-1(b) of the tax regulations describes a concept known as the “fragmentation rule.” This concept refers to the fact that income from an activity can be subject to UBIT even if the activity is a part of a larger aggregate of similar activities or endeavors which may or may not further the organization’s exempt purpose. The most common application of this rule is with advertising included in a publication that includes editorial content that is related to an organization’s tax-exempt purpose. Such advertising will still be considered an unrelated trade or business even though it is part of a large activity that furthers an organization’s exempt purposes. The previous examples described under “type of customer and context of sale” could also very easily be viewed from this perspective as well.

## **Conclusion**

Congressional and IRS attention to UBI reporting is not new. If you think that your organization might be conducting activities that could qualify as “unrelated,” you should contact your tax advisor to determine what steps you may need to take comply with current tax law on this issue.

Remember, UBI is taxed to prevent unfair competition between tax exempt and taxable organizations. It can be generated either directly or indirectly. And although current IRS compliance appears to be targeting colleges and universities, churches and religious organizations should be aware of the issues regarding UBI and address them accordingly. Stiff financial penalties are imposed by the IRS on organizations that fail to identify and file required returns.

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