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Strengthening Communities Through Legal Services

www.clccrul.org/community-law-project

Legal Alert: Unrelated Business Income Tax

Why is Understanding Unrelated Business Income Tax Important?

Unrelated business income tax (UBIT) was created in response to the popular perception that tax-exempt organizations were unfairly competing with for-profit businesses. As nonprofits are increasingly looking for creative ways to generate income, UBIT issues frequently arise. Tax-exempt organizations should understand what unrelated business income is because failure to report such income may subject the organization to back taxes, interest, and penalties. Moreover significant unrelated business activity could jeopardize an organization's tax-exempt status.

What is an Unrelated Business Activity?

An activity constitutes an unrelated business activity if the following three conditions apply: (1) the activity is a trade or business; (2) the activity is regularly carried on; AND (3) the activity is substantially unrelated to furthering the exempt purpose of the organization. Income generated from an unrelated business activity will generally be subject to UBIT, unless an exception applies. A brief review of each of the conditions is helpful.

First, a trade or business consists of selling goods or performing services to generate income. For example, an organization that sells advertisements in its publications and an organization that sells products to the general public are both engaging in a trade or business. For many tax-exempt organizations, charitable gaming has become a significant source of income; however, unless the gaming falls under the exception for traditional bingo, it is a trade or business likely subject to UBIT. *For more information regarding charitable gaming, contact your attorney or the Community Law Project.*

Second, a trade or business is regularly carried on when it is likely to compete with a similarly situated for-profit business. Under this analysis, even a seasonal operation might suffice. For example, a nonprofit organization that sells Christmas trees in November and December competes with taxable business entities conducting the same activity. So even though the activity is carried on for only two months of the year, it is considered to be regularly carried on. On the other hand, a fundraising dance held once every spring would not trigger this requirement.

Third, to be substantially related to furthering the exempt purpose of the organization, the activity itself must contribute importantly to accomplishing the mission of the organization. This is the most complicated issue of the UBIT test and involves a careful review of the underlying facts. It is important to look at how the income is earned and not how it is used. For instance, just because the income generated by an activity is used to support the organization does not mean the activity is substantially related to the organization's exempt purpose. For example, a nonprofit school which trains children in the performing arts and presents performances to the general public would not be subject to UBIT for charging admission fees because participation in front of audiences is essential to the students' training. Similarly, a community organization focused on job skills training which has program participants make and sell candles as part of their training is substantially related to the exempt purpose of the organization. On the other hand, if the organization's exempt purpose is to feed the homeless and it sells candles to fund its programs, the sale of candles is not substantially related to furthering its exempt purpose even though the funds are needed. In some instances, a business activity may be partially related and partially unrelated to the organization's exempt purpose. For example, a Chicago museum would not have to report unrelated business income on sales of reproductions of art works because such sales contribute to the museum's exempt educational purpose; however, sales of Chicago related souvenirs would be subject to UBIT because such sales are not related to the museum's exempt purpose. *For more information regarding the application of the UBIT test to the facts of your organization, contact your attorney or the Community Law Project.*

What May Be Excluded or Exempted from Unrelated Business Activity?

Generally, passive income is not included as unrelated business income. Passive income includes, for example, interest and dividends, rents from real property, gains from property sales, and royalty income.

In addition, some activities that meet the requirements for unrelated business activity are excluded from the definition. Some of the most common examples include the following: (1) business activities in which at least 85% of the work is performed by volunteers; (2) the sale of donated merchandise; (3) the distribution of low-cost articles with a request for contributions; and (4) qualified sponsorships. The last exception is generally more difficult to apply, so additional explanation is provided here.

Similarly, an organization which solicits and receives qualified sponsorship payments is not engaging in an unrelated trade or business. However, an organization must distinguish such payments from the sale of advertisements, which is subject to UBIT. A qualified sponsorship is limited to neutral descriptions of the sponsor like the business name, logo, slogans, and contact information. Advertisements, on the other hand, consist of things like descriptions of quality, price information, and endorsements. *For more information about these exclusions and exceptions, see Tax Issues for Exempt Organization—A Primer, under the resources tab at www.clccrul.org/community-law-project or call the Community Law.*

Can Unrelated Business Income Be Reduced by Deductions?

UBIT is based on net income; therefore an organization subject to UBIT may subtract permissible deductions as long as the deductions are directly connected with the unrelated trade or business. For example, an organization cannot use an expense related to its exempt purpose to offset income from its unrelated business activity.

How Might Unrelated Business Activity Jeopardize Tax-Exempt Status?

A tax-exempt organization may engage in unrelated business activities as long as such activities do not constitute a substantial part of the organization's activities overall. Substantial unrelated trade or business may jeopardize the tax-exempt status of the organization. While the IRS has not provided a specific test to determine when an unrelated business becomes substantial, an organization should closely examine the percentage of gross receipts from the unrelated business in relation to total receipts of the organization. An organization should also monitor the time devoted to unrelated business in relation to all activities to determine if an unrelated business is substantial.

How Is UBIT Reported?

A tax-exempt organization with more than $1,000 in UBIT, after applying all exclusions and deductions, must file a Form 990-T in addition to the annual requirement to file forms 990, 990-EZ, or 990-N. An organization that expects at least $500 in UBIT must use Form 990-W to make estimated quarterly tax payments. Finally, the organization must make its business income tax return available for public inspection.

Can the Community Law Project help my organization?

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