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Unrelated Business Income Tax for Nonprofits: The Basics

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Overview

A tax-exempt organization is generally exempt from federal corporate income tax on income derived from activities that are substantially related to the organization's tax-exempt purposes. However, a tax-exempt organization may be subject to a federal corporate income tax on income derived from unrelated trade or business activities. This is known as the Unrelated Business Income Tax ("UBIT").

Definitions

An "unrelated trade or business" is any activity that meets all of the following three conditions:

- . The activity must be a trade or business;
- . The trade or business must be regularly carried on; and
- . The trade or business must not be substantially related to the purposes for which the organization was recognized as exempt from federal income tax.

An activity is considered a "trade or business" if the activity is carried on for the production of income from the sale of goods or the performance of services. Note that it is immaterial whether the activity generates a profit for purposes of determining whether the gross revenue derived from the activity is subject to UBIT. Further, if an organization engages in a substantial amount of non-exempt activities, it could potentially lose its tax-exempt status even if those activities do not generate a profit.

In determining whether an activity is "regularly carried on," the IRS will examine whether the activity is conducted often and continuously and how it is pursued. The IRS will compare these factors with the same or similar business activity of non-tax-exempt organizations. Discontinuous or periodic activities are generally not considered to be regularly carried on. However, periodic activities that are seasonal in nature will be considered to be regularly carried on if an exempt organization's periodic participation in such activities coincides with the participation of taxable businesses.

For an activity to be "substantially related" to the tax-exempt organization's exempt purposes, it must contribute importantly to the accomplishment of one or more of the organization's exempt purposes. If an activity is substantially related to the tax-exempt organization's exempt purposes, then the income from that activity will not be subject to UBIT. The organization's need to generate money to use for tax-exempt purposes is not sufficient to qualify as "substantially related."

Exceptions

Subject to certain limitations, the following activities are specifically excluded from the definition of unrelated business income (the code sections in brackets represent the applicable provisions of the Internal Revenue Code where these exceptions are defined):

- Dividends, interest, and annuity income [512(b)(1)]
- Royalties [512(b)(2)]
- Certain capital gains [512(b)(5)]
- Rents from non-debt financed real property [512(b)(3)]
- Certain research-generated income [512(b)(7), 512(b)(8), and 512(b)(9)]
- Qualified corporate sponsorship payments [513(i)]
- Qualified convention or trade show income [513(c)(3)]
- Income generated from volunteer labor [513(a)(1)]
- Income from certain bingo games [513(f)]

- Sales from donated merchandise [513(a)(3)]
- A trade or business carried on by a 501(c)(3) organization primarily for the convenience of its members, students, patients, officers, or employees [513(a)(2)]
- The exchange or rental of member and donor lists among other organizations tax-exempt under 501(c)(3) [513(h)(1)(B)]
- Distribution of low-cost items in connection with charitable solicitation [513(h)(1)(A)]
- Certain hospital services provided at or below cost [513(e)]
- Qualified public entertainment activity [513(d)(2)]
- Income from services provided under a federal license by a religious order or its educational institution [512(b)(15)]
- Qualified pole rentals by a mutual or cooperative telephone or electric company [513(g)]
- Member income of mutual or cooperative electric companies [512(b)(18)]
- Certain debt management plan services [513(j)]

Payment

Organizations that generate at least \$1,000 of gross unrelated business income must file a Form 990-T, Exempt Organization Business Income Tax Return, to report unrelated business income and pay any tax due. The organization must file Form 990-T in conjunction with its annual information return (i.e., Form 990, Form 990-EZ, or Form 990-PF).

An organization may take a number of tax deductions when computing UBIT. The IRS permits a specific deduction of \$1,000. Similarly, the IRS permits deductions for net operating losses, provided that it does not take into account any amount of income or deduction that has been excluded from the unrelated business income calculation.

Organizations may take a charitable contribution deduction of up to 10 percent of the amount of unrelated business taxable income, computed without regard to the deduction for contributions. In addition, the IRS permits deductions for expenses that are “directly connected” with the carrying on of the unrelated trade or business. Note that special rules are applicable to the calculation of UBIT from advertising in periodicals.

If an organization regularly conducts two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to such activities. Where the value of the income exceeds the allowable deductions, the organization must pay a tax on the net unrelated business taxable income. This tax is generally imposed at the applicable (graduated) federal corporate income tax rates. An organization must pay quarterly estimated taxes prior to its annual information return filing date if its expected tax for the year will be \$500 or more.

Protecting Tax-Exempt Status

A tax-exempt organization could jeopardize its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is “substantial” in relation to the organization’s tax-exempt functions. To avoid jeopardizing its tax-exempt status, an organization substantially engaged in one or more unrelated business activities should consider creating one or more taxable corporate subsidiaries in which to house and carry out such activities.

Such subsidiaries are separate but affiliated organizations, generally wholly-owned by the parent tax-exempt organization. A subsidiary will pay corporate income tax on its net income. But the tax-exempt parent’s exempt status will remain. Moreover, the subsidiary can remit the after-tax profits to its parent as tax-free dividends. Note that using a pass-through entity – such as an LLC – to house unrelated business activities will not necessarily offer the same tax-related protections as a subsidiary organized as a C corporation.

Conclusion

Evaluating whether a particular activity may generate UBIT requires a fact-intensive review. While this QuickCounsel provides an overview of UBIT and its exceptions, all entities are encouraged to carefully analyze the impact of activities on the organization’s tax-exempt status and its potential tax obligations.

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