



Unrelated Business Income Tax (UBIT)

What Is It and Why Should My Exempt Organizational Clients Care?

By Hugh M. Robert

When I first started representing exempt organizations, I heard the term Unrelated Business Income Tax (UBIT) but never knew what it was or why it was important to my clients. While complex tax matters I refer to attorneys who specialize in tax, it is important to understand at least the basics of UBIT so your clients, who prior to engaging in certain activities, can understand their potential tax liability as it relates to income generating activities. This article should be a primer on the subject and is not exhaustive by any means.¹

In order for an organization to be exempt under Section 501(c)(3) of the Internal Revenue Service Code, organizations must be organized and operated exclusively for one or more of the purposes provided in Section 501(c)(3). However, treasury regulations provide a primary purpose test for its standard of “exclusivity.”² The determination of whether an organization is operated primarily for exempt purposes generally depends on an analysis of all the facts and circumstances. An organization’s unrelated business activities must be confined to something less than a substantial portion of a tax exempt organization’s overall activities.

An exempt organization is allowed to engage in some activities that are not related to their exempt purpose, or unrelated business. Nearly everything else an exempt organization does is a related business activity.

HISTORY OF UBIT

The Revenue Act of 1950³ was passed primarily as a means of eliminating a source of unfair competition with for profit businesses and mak-

ing exempt organizations pay the same tax on non-exempt business purposes. It was also seen as a more effective method than revoking the status of exempt organizations. Since 1950, UBIT has been expanded, first in 1969⁴ to include virtually all exempt organizations and then again in 1978.⁵ While unfair competition has been noted as one of the primary purposes of UBIT, many courts in their analysis have identified other objectives which are equally important.⁶

UBIT DEFINED

Generally, Section 511(a)(1) imposes a tax on “unrelated business income” of tax-exempt organizations. The term “unrelated business income” is defined in section 512(a) as “the gross income derived by any organization from any unrelated trade or business...regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business.”⁷

Unrelated Business Income Tax is applied to income that is 1) from a trade or business, 2) that is regularly carried on by the exempt organiza-

tion, and 3) where the conduct is not substantially related to organization's exempt function. Where an exempt organization has unrelated business income, they must provide the amounts and activities on IRS Form 990-T.

Trade or Business?

The treasury regulations have generally defined a trade or business as any activity that is carried on for the production of income from the sale of goods or performance of services.⁸ The IRS also looks to see whether or not there is a profit motive to the activity.⁹ Courts have interpreted this as when an activity is "purposed primarily for reasons other than the production of income, it does not constitute a trade or business."¹⁰

As with any rule, there are exceptions. An exempt organization can have something used for dual purposes. For example, where an exempt organization has facilities that are primarily used for an exempt purpose, but also uses it for a non-exempt purpose, only the revenue generated by the non-exempt activities would be subject to UBIT. One example is a university using its facilities to hold football camps over the summer that generate revenue. Its use during the regular academic year where it is supporting the educational mission of the university would not be subjected to UBIT, however the football camp revenue would. Another example is where a tax-exempt educational institution rents rooms to individuals other than students.¹¹

Dual purpose use is one that many exempt organizations overlook as "most of the activities" are related to their exempt purpose, but often have uses that fall outside the scope of their mission. A recent tax court decision illustrates this point, where a homeowners association was renting out their parking lots at their beach club during the evening hours to third parties. The tax court found that while during the day only the members and guests were allowed to utilize the facilities, thus fulfilling its mission/purpose, after 4 p.m., it leased out the parking lots to third-party businesses and therefore fell outside its mission.¹²

A second exception is where the overall activity may be related to the organization's exempt purpose but a portion of it is not.¹³ In this instance, the IRS has the authority to apply the "fragmentation rule" where an "activity does not lose identity as trade or business merely because it is carried on within a larger

aggregate of similar activities or within a larger complex of other endeavors which may, or may not be related to the exempt purpose of the organization."¹⁴

Another exemption is where goods are sold in an exempt function activity. Examples of such are goods that are made by disabled persons and sold by an organization that employs and assists them as their mission. There are limitations to this exemption where the organization has used the exempt function activity beyond what is necessary to accomplish the intended purposes.

Regularly Carried On By the Exempt Organization

In order for UBIT to apply, the exempt organization must "regularly carry on" the unrelated business activity. Generally, when an income generating activity occurs with frequency and continuity, and can be compared with the activities of non-exempt organizations, it will most likely meet the "regularly carried on" requirement. For example, if an organization has its annual fundraising event for its charitable purpose, generally that would not be considered "regularly carried on."

However, if the organization sells advertising for an annual ad book where they solicit extensively throughout the year, it could be seen as "regularly carried on." The NCAA challenged this position and the 10th Circuit overturned U.S. Tax Court. The NCAA sold advertising for its program for the basketball tournament and did not report the revenue as UBIT on its return. The court held that "the NCAA's involvement in the sale of advertising space was not sufficiently long-lasting to make it a regularly carried on business solely by reason of its duration and that the activity was sufficiently infrequent to preclude a determination that it was regularly carried on. (because it was only published once per year.)"¹⁵ The IRS has announced it will not follow the NCAA case outside the 10th Circuit and has since assessed UBIT for similar activities.

Substantially Related to Organization's Exempt Function

The "substantially related" determination is one that is a factual question based on the activity in question and the mission or exempt purpose of the organization.¹⁶ The IRS looks at each fact, circumstances and missions of the organization.¹⁷ If the activity supports or fur-

thers the organization's exempt purposes, then the income produced will not be unrelated business income.¹⁸ For example, if a folk museum sells prints of the works of art it has displayed as part of its collection, it will likely be found to be related to the exempt purpose of the museum. If however, the same fine art museum decided to sell science books for kids, it would not be found to be substantially related to the museum's exempt purpose, even though it could fall under the educational purpose as found in Section 501(c)(3).¹⁹

Exclusions Under Section 513

Even if an activity meets the definition of an unrelated trade or business, it may not be subject to UBIT if it meets one of the statutorily provided exclusions. Some of the exclusions include:

Volunteer Labor – Any activity in which substantially all the work of the trade or business (probably 85 percent) is performed without compensation is immune from tax. In assessing the contribution made by volunteers, such factors as the monetary value of the services rendered, the number of hours worked, the intrinsic importance of the volunteer work performed, and the degree of reliance placed upon volunteers should be considered (Reg. 1.513-1(e)(1)).

Donated Merchandise – Any unrelated activity involving the sale of merchandise, substantially all (probably 85 percent) of which was received as gifts or contributions, is exempt regardless of whether the labor to operate the activity is paid or volunteer (Reg. 1.513-1(e)(3)). (i.e. thrift shops).

Business or trade carried on primarily for the convenience of students, members, patients, or employees. For example, a university gift shop or cafeteria where its operation is primarily for the convenience of students. This is not without limitation, if the gift shop sells items such as watches, CDs or DVDs.

Exclusions Under Section 512(b)

There are a number of activities that are exempt from treatment as unrelated business found in Section 512(b) of the code. Two of the most common exclusions are related to intellectual property, specifically, income derived from research and royalties.

Research performed for the "United States or any of its agencies or instrumentalities, or any state or political subdivision thereof is excluded

ed from UBIT."²⁰ Colleges and university research is also excluded from UBIT where performed for any person by colleges, universities and hospitals.²¹ Additionally, "fundamental research" is also excluded so long as it meets the criteria as defined by Section 512(b)(9).²²

Royalty income is also generally excluded from UBIT as provided for in Section 512(b)(2). This includes payments for a variety of intellectual property rights such as the use of logos of an exempt organization. The IRS has defined royalties as "a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purpose."²³

One recent opinion involved a credit union that granted the use of its goodwill and customer list in connection with the sale of accidental death and dismemberment insurance. Here, the court held that the income from the granting of use of intangible property constitutes royalties that are not subject to UBIT.²⁴

However, the royalty exemption does not include income derived from services, such as personal appearances or endorsements of products.²⁵ This is an area that has quite a few cases that have produced varying results. Specifically, the IRS has varying interpretations as to whether a payment received by an exempt organization is a royalty for purposes of the exclusion from UBIT. One line of cases involves exempt organizations agreements with affinity credit cards²⁶ and another involves exempt organizations renting their mailing lists.²⁷

Royalty income on development can also be seen as exempt depending on the circumstances. In a private letter ruling, the IRS found a private foundation was not responsible or liable for operating costs or liabilities attributable to the for profit corporation's developing, exploring, equipping, owning, operating, and/or maintaining oil and gas properties – or for storing, handling, treating, or marketing oil or gas, where the foundation invested in the corporation and receives net profits interest.²⁸ However, that is not the end of the discussion, Section 1.512(b)-1(b) provides that "overriding royalties and deductions connected with such income shall be excluded in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by

production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded." In the scenario described by the IRS, the foundation did not have more than a net profits interest.

CONCLUSION

It is highly recommended that an organization monitor its unrelated business income activities to ensure that it is still delivering its mission and not just spending time generating revenue. If an organization does not stay focused on its mission and exempt purpose, it could jeopardize its tax exempt status. One suggestion for organizations that have a substantial amount of unrelated business income activity to consider is for those activities to be put into a subsidy. As exempt organizations look at alternative or new means of income activity, they should analyze whether UBIT will apply. Even if income activities generate revenue to sustain the mission of the organization, it is not good enough to exempt the organization from having to pay UBIT as it is not what the income is used for, rather where the money came from.

1. For a full discussion on UBIT and the various tests mentioned in this article, I recommend *The Law of Tax-Exempt Organizations*, Tenth-edition, by Bruce R. Hopkins, published by John Wiley & Sons, Inc. 2011. See also IRS Publication 598, www.irs.gov/publications/p598/index.html.

2. Generally, unrelated business activities must be confined to something less than a substantial portion of the organization's overall activities. "An organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." Treas. Reg. §1.501(c)(3)-1(c)(1).

3. Pub.L. No. 814, §301, 64 Stat. 906, 947 (1950).

4. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 541.

5. Pub. L. No. 95-502, 92 Stat. 1693, 1702 (1978).

6. *Louisiana Credit Union League v. United States*, 693 F.2d 525, at 540-541 (5th Cir. 1982). "Congress enacted the predecessors of section 511-513 to eliminate a perceived form of unfair competition, that aim existed as a corollary to the larger goals of producing revenue and achieving equity in the tax system."

7. *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982)

8. Treas. Reg. §1.513-1(b).

9. Courts have also looked to whether or not there is a motive for profit in determining whether or not an income generation activity can be deemed a trade or business. See *United States v. American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986).

10. *Carolina Farm & Power Equipmt. Dealers Assoc. v. United States*, 541 F.Supp. 86 (E. Dist. N.C. 1982).1. The court held that in order for an activity to reach the level of a trade or business, it must "be operated

in a competitive, commercial manner." Citing *Disabled American Veterans v. United States*, 650 F.2d 1178, at 1187 (Ct. Cl. 1981).

11. See PLR 201106019.

12. *Ocean Pines Assoc. Inc. v. Comm'r*, 135 T.C. 13 (2010).

13. Generally, an exempt organization's revenue derived from advertising in its magazine or periodical is regarded as an unrelated business and subject to UBIT. There are of course even exceptions to this, for example, a student run newspaper that has advertisers that are commercial in nature, can be exempted from UBIT as the advertising revenues contribute to the university's mission and educational development by providing training to the students.

14. IRC §513(c); Treas. Reg. §1.5134-1(b).

15. *National Collegiate Athletic Ass'n v. Commissioner*. 914 F. 2d 1417 (1990).

16. Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. 26 C.F.R. §1.513-2(a)(4).

17. This includes examination of the Articles of Incorporation of the Association. See *Anateus Lineal 1948 Inc. v. United States*, 366 F. Supp. 118 (W.D. Ark. 1943); and *Carolina Farm & Power Equipmt. Dealers Assoc. v. United States*, 541 F.Supp. 86 (E. Dist. N.C. 1982). The assessment of whether the production or distribution of goods or performing of services involved and accomplishment of organization's exempt purpose "depends in each case upon the facts and circumstances involved." *Bellco Credit Union v. United States*, 735 F. Supp 2d 1286 (D.C. Colo. 2010) citing 26 C.F.R. §1.513-1(d)(2).

18. For an activity to be considered substantially related, the activity must "contribute importantly" to accomplishment of the organization's exempt purposes. Treas. Reg. §1.513-1(d)(2)

19. Rev. Rul. 73-105, 1973-1 C.B 264, www.irs.gov/pub/irs-tege/rr73-105.pdf.

20. Section 512(b)(7).

21. Section 512(b)(8)

22. This exclusion is limited to organizations that engage primarily in fundamental research.

23. Rev. Rul. 81-178, 1981-2 C.B.135, www.irs.gov/pub/irs-tege/rr81-178.pdf.

24. *Bellco Credit Union v. United States*, 735 F. Supp 2d 1286 (D.C. Colo. 2010).

25. *Id.*

26. *Sierra Club Inc. v. Comm'r*, 86 F.3d 1526 (9th Cir. 1996), *Oregon State Univ. Alumni Ass'n Inc. v. Comm'r*, 193 F.3d 1098 (9th Cir. 1999)

27. See *Disabled American Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981); *Sierra Club Inc. v. Comm'r*, 86 F.3d 1526 (9th Cir. 1996); and *Planned Parenthood Fed. of Am. Inc. vs. Comm'r*, 77 T.C.M (CCH) 2227 (1999).

28. PLR 201142026.

ABOUT THE AUTHOR



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