MARY ANTONETTI, CPA

Expanding Your Offerings

UBIT, UBI the alphabet soup of IRS compliance

One thing the past few years taught everyone is the need to evolve, and that's as true for individuals as it is the organizations they manage. Organizations where leaders are unwilling or able to keep pace with the changing world are withering on the vine rather than thriving.

External factors like the shifting generations in the workforce, remote work, political conditions, social media, and economic events are changing how organizations function. As your nonprofit adapts, it's essential to keep in mind that expanded services must remain aligned with organizational goals or become subject to unrelated business income tax (UBIT).

Keeping Mission In Focus

Organizations granted tax-exempt status under section 501(c)(3) of the Internal Revenue Code are organized and operated exclusively for its exempt purpose. None of the earnings a 501(c)(3) generates may inure to benefit any private individuals.

Generally, exempt purposes are charitable, religious, educational, scientific, or related to public safety, fostering national or international sports competitions, and the prevention of cruelty to children or animals. When the Application for Recognition of Exemption Under Section 501 (c)(3) of the Internal Revenue Code (Form 1023) is completed, the Internal Revenue Service (IRS) is presented with information about the exempt purpose, mission, and the various programs organized to carry out the exempt purpose as stated.

UBIT And Your Nonprofit

Since tax-exempt organizations are believed to relieve some of the burden on government, they have a tax advantage compared to other types of organizations. This benefit only extends to activities related to the organization's tax-exempt mission. Organizations must pay UBIT on any net income generated by an activity not directly tied to their mission. Unrelated business income is often generated in an attempt to open new sources of revenue. Remember that tax exemption is determined by how you earned income, not how it is spent.

Regulation Section 1.1513-1 provides that unrelated business income (UBI) is income from an activity that is from a trade or business regularly carried on by the organization, and the conduct of such trade or business is not substantially related to the organization's performance of its exempt purpose. The mere fact that the activity raises revenue for use in the exempt purpose of the organization does not exclude the activity from being unrelated business income.

Unrelated business taxable income (UBTI) is the net amount taxable to an organization after the UBI is reduced by expenses. The purpose of the tax is to mitigate any unfair advantage a tax-exempt organization may have over tax-paying organizations performing the same activity.

Which Activities Qualify As UBI

An activity carried on for the production of income, including the selling of goods or performance of services, may generate UBI if it is regularly carried on and not substantially related to the organization's exempt purpose. When evaluating if an activity might be unrelated business income activity, consider if there is a profit motive associated with that activity and if the manner of operation is similar to how commercial companies make a profit.

Once an organization determines if the activity rises to the level of a trade or business, the next step is to assess the frequency of the activity. Is the activity a one-time event or something ongoing?

Many fundraising activities are excluded from UBI because they are not regularly carried on. For example, annual golf outings are a common event that might include a golf tournament in which donors play golf and have dinner. Since the tax-exempt organization is not in the business of running a golf course, this activity is probably not related to its exempt purpose.

And, since the provision of golf and dinner are goods and services being sold and of value to donors, the activity is a trade or business. However, since this activity is not regularly carried on, it may be excluded from unrelated business income. The IRS does not provide a safe harbor as to what is "regularly carried on," each organization will need to assess each activity based on the facts involved.

The final prong is to assess if the activity is substantially related to the organization's exempt purpose. This test is specific to the organization. For example, a school and a soup kitchen are tax-exempt for different reasons. Both organizations may decide it is beneficial to start a daycare. For the school, that activity may fall under the exempt purpose of the organization but probably would not be considered related to the exempt purpose of the soup kitchen. More specifically, if the school's mission is broad enough, developing a curriculum for the education of 3- and 4-year-old children may fall under the exempt purpose. Alternatively, the school may be a university with an early childhood development program run by students as part of their classwork.

These are just a few ways the daycare might be related to the school's exempt purpose. On the other hand, the food pantry's exempt purpose is to give food to people in need throughout the community. The provision of daycare services would not directly relate to the pantry's exempt purpose.

In this hypothetical, you can see how any single activity must be analyzed in a broader context to determine whether or not it qualifies as UBI.

UBI Exclusions

Certain items such as interest, dividends, capital gains, and unleveraged rent of real property are excluded from unrelated business income. However, the rules are complex, and you should consult a tax advisor when pursuing new activities or investments.

For example, a church may choose to rent its downstairs space to the community. The rental of the space might not generate UBI. However, if the church provides food and cleaning services, it is no longer simply renting real property. In this case, the church is now providing the rental property with the provision of services, making it subject to unrelated business income tax. That same church may rent the room for a wedding or christening. In that case, the rental may be part of a religious activity relating to its exempt purpose. Each rental activity must be examined separately to see if it meets an exclusion.

Generally, investment income is exempt from unrelated business income, but beware, if money is borrowed to buy an investment, the investment is now considered to be debt-financed. Any interest, dividends, and capital gains once statutorily excluded might now be subject to unrelated business income tax.

Many tax-exempt organizations are invested in joint ventures with a knowing partner or through a private equity investment structure. If the resulting joint venture is a partnership and a Schedule K-1 form is issued, there might be tax impacts, including pass-through unrelated business income and foreign and state filing requirements. If a Schedule K-1 form provided by the partnership includes ordinary income, the organization must determine if the income passed through to it is part of the exempt purpose.

One activity that usually generates unrelated business income is advertising. Characteristics of advertising include:

- Comparative or qualitative language.
- Price, savings, or value information.
- Endorsements.
- Inducements to buy.

A sponsorship where there is no substantial return benefit may be viewed differently by the IRS. For example, sponsorships are often sold for golf tournaments. As a tee sponsor, the sponsor has a sign with the company's name and logo. If the sign provides information about the company, how to purchase its products, etc., it is no longer an acknowledgment. It is advertising which generates UBI.

The line becomes more difficult to decipher when advertising moves into the online realm, including websites and social media. Managers need to understand and evaluate all contracts that involve putting companies or products on the organization's website. If the website allows a click-through link directly to purchase the product, the revenue received may not be classified as a donation but as advertising revenue. One organization engaged with a for-profit entity to sell ugly sweaters for Christmas. In return, the nonprofit received a percentage of every sale generated through a fundraiser hosted on the charity's website. At first pass, this activity seemed like an easy way to generate funds, but because of the treatment of advertising, the arrangement led to several UBI implications.

The rules for unrelated business income are complex. Two organizations might provide the same goods or services with different results as to UBI.

As long as an organization is operated primarily for its exempt purpose, some amount of unrelated business income is allowable. It is essential that the nonprofit's management and board understand the tax implications of the activity and that decisions are made with an appreciation for any potential tax and compliance implications.

Nonprofit leaders need to know that it is not what you do with the money. It is how you earned it that generates unrelated business income. NPT

Mary Antonetti, CPA, is partner, Tax & Business Services, at Marcum LLP. Her email is mary.antonetti@marcumllp.com