UBIT: CLOSE CALLS AND TRAPS

Outcomes Conference 2024

More than ever, nonprofit organizations are looking at innovative ways to generate extra funding, and the rules defining when those activities become taxable are not always clear. Join us to discuss common scenarios that fall close to the line.

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Presentation Outline:

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1. **Foundations**
    a. Tax-exempt organizations are permitted to undertake activities unrelated to their exempt purposes as long as they are insubstantial
    b. However, organizations must pay tax (referred to as unrelated business income tax or UBIT) on net income generated on unrelated trade or business activities at the normal corporate income tax rate
    c. Purpose of UBIT: prevent tax-exempt entities gaining unfair competitive advantage
    d. UBIT is reported on Form 990-T, even if your organization is exempt from filing Form 990
2. **Elements of UBIT**
    a. 3 conjunctive criteria for UBIT:
        i. Trade or business
            1. Any activity carried on for the production of income involving the sale of goods or services
            2. 2 keys:
                a. Do the activities generate a profit?
                b. Are the activities similar to those conducted by for-profit companies?
        ii. Not substantially related to exempt purposes
            1. Key: do the goods or services provided "contribute importantly" to the accomplishment of the organization's exempt purposes? (Treas. Reg. § 1.513-1(d)(2))

        2. Using the generated funds to support exempt purposes not relevant
        3. Depends on the exempt purposes of the specific organization
    iii. Carried on regularly
        1. Key: is the frequency and continuity of the activities and manner in which they are pursued similar to comparable commercial activities?
        2. Unrelated trade or business activities are not taxable if they are not carried on regularly

3. **Common Exceptions and Exclusions**
    a. Substantially all work performed by volunteers (§ 513(a)(1))
    b. Sale of donated items (§ 513(a)(3))
    c. Dividends and interest (§ 512(b)(1))
    d. Royalties (§ 512(b)(2))
    e. Rents from real property (§ 512(b)(3))
    f. Others – see §§ 512 and 513 for the full list

4. **Close Calls and Traps**
    a. Sale of goods (e.g., souvenirs, apparel)
        i. Trap: Common misperception that using proceeds to fund exempt activities makes the revenue nontaxable
        ii. Close call, depending on a fact intensive inquiry around the following factors:
            1. Characteristics of items sold
            2. Intended use by buyers
            3. Sales methods of the organization
        iii. Examples: Rev. Rul. 73-104; PLR 8622005.
    b. Renting out venue space
        i. Trap: Common misperception that all rent is exempt from UBIT
        ii. Traps and pitfalls to look out for:
            1. License Agreements (PLR 9740032)
            2. Personal property leased along with real property (§ 512(b)(3)(A)(ii))
            3. Acquisition indebtedness (§ 512(b)(4), § 514)
            4. Services rendered to the occupant
            5. Calculation of rental fee
    c. Providing services to another tax-exempt entity (or entities)
        i. Trap: Common misperception that these services are categorically not taxable

   ii. Watch out for services that are similar to those provided by for-profit businesses
   iii. Helpful facts:
      1. Relationship with entity (or entities) for whom providing services (Treas. Reg. § 1.502-1(b); Rev. Rul. 77-72)
      2. Charging below cost (Rev. Rul. 71-529)

d. Providing commercial services to the public
   i. Trap: Common misperception that these services are categorically taxable
   ii. Case studies: outdoor recreation, catering

e. Corporate sponsorships
   i. Close call: does the sponsor receive a substantial return benefit in exchange?
   ii. This is a facts and circumstances test
   iii. Use or acknowledgment of the name or logo is not a substantial benefit (§ 513(i); PLR 9505001)
   iv. Revenue from "advertising" is generally subject to UBIT

f. Publishing
   i. Close call: depends on a number of factors, but most important is how similar the activities are to a for-profit publisher
   ii. Examples: Rev. Rul. 67-4; Rev. Rul. 77-4.

5. Recommendations

a. Do not pass up opportunities to raise revenue simply because they might generate UBIT (unless you are "close" to losing tax-exempt status, in which case you might consider forming a for-profit subsidiary)

b. When a new revenue stream is being considered, walk through the UBIT elements and exceptions/exclusions to ensure proper tax treatment of the revenue

c. When possible, try to structure income through passive sources (e.g., royalties) instead of through a business carried on by the organization to minimize UBIT