

# Does My Nonprofit Need to Pay Tax? Understanding Unrelated Business Income Tax

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While nonprofits are, generally, tax-exempt, they must pay income tax when operating outside the scope of their exempt purposes. But determining what are an organization's exempt purposes is not always as clear as one might think, and distinguishing between related and unrelated activities can be tricky. There are clear rules, as well as several exceptions to those rules, that can help guide an organization in the right direction. But, as Kupfer underscores, while this article outlines key concepts of UBIT, "specific advice should always be sought from a competent tax counsel."

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IF THERE IS ONE THING THAT PEOPLE KNOW about taxes, it is that tax-exempt organizations don't pay federal income tax. That seems simple enough. After all, if they had to pay tax, they wouldn't be "tax-exempt," right? Well, not always. While it is true that under most circumstances tax-exempt organizations are not subject to a corporate level income tax (as their taxable entity counterparts are required to pay), there are times that they *will* be subject to income tax—in this context known as the Unrelated Business Income Tax, or "UBIT" for short.

Much to the dismay of business owners, corporations and trusts pay income tax at the corporate/trust level. To ensure that tax-exempt organizations aren't given an unfair advantage

over their corporate/trust counterparts, Congress added the UBIT rules to force exempts to pay their fair share when engaged in commercial activity outside the scope of their exempt purposes.

The laws surrounding UBIT are complex. This article is not meant to cover all scenarios but is intended to provide an overview and alert readers to potential UBIT issues. Competent tax counsel is recommended for further detailed questions. In addition, the IRS's *Publication 598*, which describes the UBIT regulations, is a handy resource.

## When Will an Organization Pay UBIT?

UBIT rules require a tax-exempt organization to pay income tax when the organization regularly carries on a trade or business that is not substantially related

to the organization's exempt purposes. Let's discuss each of these elements separately.

**To be subject to UBIT, first, the organization has to carry on a trade or business.** This is pretty self-explanatory, but to be clear: trade or business will usually involve the sale of goods or services in exchange for money or something else of value for the purpose of making a profit.

**Second, the trade or business must be regularly carried on.** This means it takes place frequently or on a continual basis similar to the way the activity would be carried on by a for-profit business. (Even a seasonal business can be considered regularly carried on, regardless of the large gaps of time between sales.)

**Third, the trade or business must not be substantially related to the organization's exempt purposes.** In other words, the activity must not contribute importantly to accomplishing the organization's exempt purposes. What are its exempt purposes? This gets a bit more complex, so let's take a step back and review some background.

At the time of formation, nonprofits file a certificate (or articles) of incorporation with the secretary of state in the state of incorporation (trusts execute a trust document). The founders of the organization choose from a short list of permissible purposes in which a nonprofit is permitted to engage, and include the purposes in the certificate. Whereas a for-profit business is generally incorporated with the ability to conduct all lawful activity, nonprofits may only carry on certain activities, and in exchange they receive certain benefits when they are recognized by the IRS as tax-exempt. Depending on the kind of organization, the benefits may include the ability to receive tax-deductible contributions, income tax exemption, a property tax exemption, and preferred U.S. postal rates, among others.

The most common exempt purposes for charities and houses of worship are religious, charitable, educational, and scientific. While the tax regulations defining the activities that fall within each of these purposes are lengthy, suffice it to say that a church's activities will fall within religious, charitable, and perhaps even educational purposes, and such purposes should have been listed in the church's formation documents. And while an exempt school's main purpose is educational, some of its activities will also fall within the charitable category. Finally, the activities of most charities will fall within the charitable category, but if they provide some educational element, such as educating communities

regarding issues of concern to the broader public, those activities would be listed as educational. *The nonprofit, in short, may only engage in activities that contribute importantly to those exempt purposes it is authorized to conduct*—and it becomes authorized by including them in its certificate.

As an illustration, the charging of tuition by an exempt school is, no doubt, a *regularly* carried on business. But the charging of tuition is related to its *exempt* purpose, since parents are paying for the education of their children—education being the name of the game. The rule is that when a business activity is related to the exempt purpose, it may be carried on even substantially, with the organization never having to pay UBIT. Similarly, in the case of a church charging its congregants membership fees and dues, this is a regularly carried on business but it is related to its exempt purpose—admission for the purpose of prayer, which falls squarely within a church's religious function. From these examples we see an interesting point: *there is no prohibition for a nonprofit to make money, so long as it does so by carrying on an activity related to its exempt purposes.* Of course, the organization is restricted with regard to what it may do with that money; generally, it may only use the money to pay reasonable compensation and necessary expenses. It is subject to the restrictions on private inurement and excess benefit transactions.

In determining whether an activity is *related*, we look to the activity itself and not to where the profit from the activity may go. So, if an activity itself does not contribute to the organization's exempt purposes, the act of applying the proceeds to fund the organization's exempt purposes does not make the activity related.

For example, what if, in an attempt to raise funds, the school started a

retail clothing business located across the street, where it sold clothing to the general public at market value? The retail sale of clothing does not fall within any of the school's exempt purposes, and so it is *unrelated* regularly carried on business activity. As noted above, it will be unrelated regardless of the fact that the proceeds go to benefit the school's core function of educating students.

Once we have a regularly carried on trade or business that is unrelated, the next question to ask is whether it is substantial or insubstantial compared to all else that, to stay with the above example, the school does. If it were *insubstantial*, the school would be required to pay UBIT to the Internal Revenue Service. This is a tax at the current tax rate for the net profits the organization earns by running the unrelated business. If, however, the school's business really took off and became *substantial*, as compared to the rest of the activity conducted by the school as a whole, then in addition to being required to pay the UBIT the school would be at risk for losing its tax-exempt status, since it would no longer be primarily engaged in its tax-exempt purposes as required by section 501(c)(3) of the Internal Revenue Code—the source for its tax exemption.

While weighing whether a trade or business is substantial or insubstantial is subjective and depends on the specific details of the case at hand, one may want to think of it in terms of which activity is *primary* and which is *secondary*. Taking the organization as a whole, the question to ask is whether—going back to the school example—this is a school that happens to have a small clothing business or whether it is really a clothing business that also has a school. This can be measured by many factors, including revenue, size, and extent of the various activities (because it varies based on

the specific case, it would be prudent to make this determination in consultation with a tax counsel). Although it has never been clearly defined, many practitioners agree that, as a rule of thumb, an organization's net income generated from unrelated activity should not exceed 20 percent of its overall net income.

In addition to paying the tax, an organization with \$1,000 or more of gross income from unrelated business is also required to file a Form 990-T (by the fifteenth day of the fifth month after the end of its tax year). Note that this filing is required regardless of whether the organization is otherwise required to file a Form 990 (so a church would not be exempt from this filing). If the organization anticipates paying \$500 or more of UBIT for the year, it is required to pay the tax in quarterly estimated payments.

### What are the Exceptions?

There are several exceptions where unrelated and regularly carried on business activity will not be subject to UBIT.

#### *Convenience Exception*

First, where the business is performed primarily for the convenience of its members, students, patients, officers, or employees, UBIT will not apply. For example, a nonprofit hospital's cafeteria is obviously a regularly carried on business. However, because it is there primarily for the convenience of the patients, employees, and guests, its net income would not be subject to UBIT. To the extent it is used by the general public (i.e., those who have no connection to the hospital), its net income generated by outsiders would be subject to UBIT. Additionally, if it did more than necessary such that it could no longer be called a simple convenience—if the hospital were to open a five-star restaurant, for instance—the net income attributable to anything more than what

is necessary for the convenience of its patients, staff, and visitors would be deemed unrelated. A laundry run by a school is another example of a business operated for the convenience of its students, and, thus, its net income would not be subject to UBIT. A school's or hospital's vending machines would also fall within the convenience exception, and not be subject to UBIT.

Items sold at a tax-exempt organization's gift shop are scrutinized on an item-by-item basis to determine whether the sale of each item is related to the exempt purposes of the organization. For example, there is a museum—a tax-exempt organization—that has a gift shop and an online store, each of which does a substantial amount of sales, yet the museum only infrequently pays UBIT. Items possess an imprint of art images (which is seen as acting in furtherance of the museum's educational purposes by making works of art more familiar to a broader segment of the public), and, thus, are considered to be related to the museum's exempt purposes. However, such souvenir items as T-shirts or mugs featuring an emblem of the museum's location or the museum's logo would be viewed as not contributing importantly to the accomplishment of the museum's exempt purposes, and would be subject to UBIT.

#### *Sale of Donated Property*

UBIT doesn't apply to the sale of donated property. Thus, sales by thrift shops or bake sales by a tax-exempt organization—so long as the sale goods were donated—would not be subject to UBIT. Also falling within this exception would be a tax-exempt organization that receives donated used cars and subsequently sells them to earn money that is then applied toward the organization's mission—even though the sale of the donated cars would otherwise be regarded as unrelated trade or business.

Applying this rule to our school retail clothing store example from earlier, if the store only sold items it received as a *donation*, it too would fall within this exception. (Do keep in mind, however, that the organization's sale of donated property creates limitations to the amount the donor may deduct from his or her taxes.)

#### *Work Performed by Unpaid Volunteers*

Work performed by unpaid volunteers is not considered an unrelated trade or business. Thus, to continue with our example above, if substantially all of the work at the school's clothing store were accomplished through the work of unpaid volunteers, it too would fall within the exception.

#### *Passive Investments*

Income derived from passive investments, such as dividends, royalties, interest, and capital gains, is not subject to UBIT. Thus, if a tax-exempt organization invests in publicly traded stock and receives a dividend, or sells the stock and realizes a capital gain, such dividend/gain is not subject to UBIT. Similarly, if the organization earns interest on its bank account, the interest is not subject to UBIT.

Income derived from the rental of real estate is considered passive and falls within this exception so long as the organization only *rents* out the space and does not provide personal services. (Note, though, that passive income from the rental of personal property is subject to UBIT). Thus, if an organization derived income from renting hotel rooms, rooms in boarding houses or tourist homes, or space in parking lots or warehouses, this exception would not apply (and the net income would be subject to UBIT) because some element of personal service was provided in addition to the space.

So let's say an organization operated a parking lot for a fee (and assume it did not fall into the convenience exception)—this activity would be considered unrelated. If, however, the organization leased a sizeable plot of empty space it owned to a company for a fixed fee to operate a parking lot (and the company handled everything, and all the organization provided were the typical services generally provided by a landlord), this would be considered passive rental income, and would fall within the exception. If, however, the rental fee paid to the organization were tied to the success of the parking company, this would be a joint venture between the organization and the business. The rule is that a joint venture, where the rent or dividend is dependent on the success of the venture, is not considered to be passive. So if the amount paid by the rental company were tied to the success of the business, it would not fall within the exception and would be subject to UBIT.

It should be kept in mind that even if one exception is not available, another may apply. To illustrate, if the parking lot were operated primarily for the convenience of the organization's guests and employees, it would fall within the convenience exception or otherwise be considered related to the purposes of the organization, as it may contribute importantly to the use of the organization's facilities. If, however, it were used by members of the general public, who had no connection to the organization and simply sought to avail themselves of the parking facility, the net income generated by such members of the public would be subject to UBIT.

To illustrate the passive investment exception further, if an organization is a partner in a partnership (or LLC) engaged in unrelated business (even as a silent partner), or if it owns S Corporation stock (any S Corporation stock,

regardless of whether or not the business of the S Corporation is related to the purposes of the organization), it would have to report the income from its partnership and S Corporation holdings as unrelated taxable income. If, however, the organization (or the partnership in which the organization is a partner) owns stock in a corporation and receives a dividend, such dividend would fall within this passive investment exception.

The tax regulations explicitly state that the rental of space in a warehouse or storage garage does not fit within the passive investment exception and would be subject to the general UBIT rules. Regulations also make clear that the income an organization generates by placing cell towers or antennae on its building's roof in order to rent space to cell-phone carriers does not fall within the passive investment exception, as this would be deemed the rental of personal property, which, as we have seen, does not get the benefit of the exception.

It is important to note, however, that this passive investment exception generally does not apply to any income from a passive investment that was acquired through debt financing—for example, borrowed funds, such as a mortgage. So, if an organization borrows in order to conduct unrelated passive investments, the net income earned from the investments would be subject to UBIT in proportion to the debt on the property—and, if substantial, could risk the exempt status of the organization. (The rules regarding the above exception are particularly complex, and a tax counsel should be consulted in the event of such a situation.)

#### *Low-Cost Items*

Some organizations send potential donors a low-cost item (such as a coffee mug or key chain) sporting the

organization's logo to help induce them to donate. Under this exception, such a distribution will not be seen as a sale (when the donor ends up making a donation) if the donor did not request the distribution, the distribution is made without the express consent of the recipient, and the item is accompanied by a request for a charitable contribution to the organization, along with a statement that the recipient may keep the item regardless of whether or not he or she makes a contribution.

### **Some Additional Examples**

The tax regulations make it clear that “income derived from the conduct of an annual dance or similar fundraising event for charity would not be income from trade or business regularly carried on.” Thus, should an organization host an annual dinner or similar event solely for fundraising purposes, the net income derived therefrom should not be subject to UBIT, as such events would not be considered to be “regularly carried on.”

If an organization sold its mailing lists or other data to an outside commercial entity, such sales would be unrelated and subject to UBIT. Similarly, if the organization maintained a website or periodical, the advertising revenue generated therefrom would generally be unrelated and subject to UBIT. A limited exception is available under certain circumstances for “qualified sponsorship payments,” where the person paying receives no substantial benefit other than the use or acknowledgment of the business name, logo, or product lines in connection with the organization's activities.

### **State Requirements**

Thus far we have discussed requirements to file and pay UBIT to the federal government. States also have their own requirements. For example, organizations that are subject to federal tax on

unrelated business income are taxable under Article 13 of the New York State Tax Law if they pursue those unrelated business activities in New York State. To report those taxes, the organization must file Form CT-13, *Unrelated Business Income Tax Return*. The rules of states vary, so specific state laws should be consulted to determine your organization's state tax liability.

In conclusion, to ensure that tax-exempt organizations aren't given an unfair competitive advantage over for-profit commercial entities, Congress added the UBIT rules to force exempts to pay their fair share when engaged in commercial activity outside the scope of their exempt purposes. When that activity is substantial, however, organizations are at risk of also losing their tax-exempt status, since at that point they no longer operate primarily in furtherance of their exempt purposes, as

required under section 501(c)(3). The rules surrounding UBIT are complex. This article has outlined some of the key concepts, but specific advice should always be sought from a competent tax counsel.

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