



Earning Income for Your Nonprofit: About UBIT (Unrelated Business Income Tax) and Why It Matters

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Scope of Presentation

- What we **will be** covering:
 - IRS rules pertaining to 501(c)(3) public charities
 - Taxes and implications of revenue-generating activities
- What will not be **not** covering:
 - Other 501(c) organizations
 - Extensive detail on revocation/denial of 501(c)(3) status



Takeaway and goals

- A 501(c)(3) public charity can engage in activity that generates revenue, but the revenue may be taxable if it is **unrelated to the organization's charitable purpose**
- A 501(c)(3) public charity cannot engage in overly commercial activity
- Learning objectives:
 - Note the three elements of unrelated business taxable income
 - Become familiar with the main exceptions to UBIT
 - Understand when certain activities may be too commercial in nature



PART I

Nonprofits and Earned Revenue



Why do nonprofits engage in earned revenue-generating activities?

- Alternative source of revenue/sustainability
- Expected by funders
- Furthering mission (i.e., the organization acts as a “social enterprise”)



How nonprofits engage in revenue-generating activities

- **Sale of goods**

- Nonprofit designed and facilitated manufacture of portable bookshelf and seating unit to further its mission of creating public spaces; sold unit to other nonprofit/gov't agencies with similar missions
- Thrift stores
- Workforce training centers
- Gift shop, snack bar, etc.

- **Revenue from services**

- Entry fees (museums, parks, etc.)
- Classes (yoga, dance, art, etc.)
- Tuition (education, training, etc.)

- **Fee-for-service work**

- Nonprofit with expertise in mobilizing youth to engage in social change efforts consults with other organizations seeking to reach youth for a fee



PART II

Unrelated Business Taxable Income



Historical context

- Pre-1950, nonprofits could engage in limitless commercial activities
 - Concerns of unfair competition (*C.F. Mueller Co.*)
 - “The macaroni monopoly will be in the hands of the universities” – Rep. John Dingell
- UBIT rules (in the Internal Revenue Code and related authority) enacted in 1950
- Today, the IRS is tasked with interpreting and enforcing those rules, and federal courts have jurisdiction to ultimately determine if IRS interpretations are correct



Tension between for-profits and nonprofits

- Alabama Dental Association opposes expansion of nonprofit providing dental services to low-income families
- Idaho Veterinary Medical Association votes to prohibit animal welfare groups from providing veterinary care
- For-profit health clubs in Boise, ID complain that the local YMCA is running programs similar to their own
 - “Is it charitable to run on a treadmill? Is it charitable to take a CrossFit class?” - Idaho Athletic Club’s CFO



Unrelated Business Taxable Income ("UBTI")

- Earned revenue may be deemed UBTI if it:
 - Is derived from a **trade or business**
 - That is **regularly carried on** and
 - Is **not substantially related** to the organization's tax-exempt (i.e., charitable or educational) purposes
- Generally speaking, if an organization's annual amount of UBTI exceeds \$1000, it is reportable on the IRS Form 990-T
- UBIT is currently imposed as a 21% flat tax rate for nonprofit corporations



Dissecting UBTI: Trade or business

- Any activity carried on for the production of income from the sale of goods or performance of services.
 - Is there a quid pro quo?
 - Is the same activity conducted in the private sector?
- Activities of producing or distributing goods or performing services from which income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other activities that may, or may not, be related to the organization's exempt purposes



Dissecting UBTI: Regularly carried on

- Activity engaged in frequently or continuously in a manner generally similar to comparable commercial activities by non-exempt organizations
 - Activities over a period of only a few weeks per year does not constitute the regular carrying on of trade or business
 - So annual recurring events are generally okay (*e.g.* running a sandwich booth at the state fair)
 - Intermittent or sporadic activities are generally not deemed regularly carried on (*e.g.* bake sale, dance, etc.)
 - But weekly activity (*e.g.* flea market) or seasonal enterprise (*e.g.* Christmas cards) is likely regularly carried on
- **Example:** NCAA March Madness advertising



Dissecting UBTI: Not substantially related

- A trade or business is related to exempt purposes only when the conduct of the business activities has causal relationship to achieving exempt purposes, and said causal relationship is substantial
- Revenue-generating activity must “contribute importantly” to the accomplishment of the organization’s tax-exempt purposes
- Income production is not considered to be substantially related to a charitable purpose simply because said income provides funding for the organization’s charitable activities



Not substantially related: Fragmentation rule

- The same trade or business may generate both related and non-related income
 - **Example:** Folk art museum shop sold art-related items as well as scientific books and miscellaneous souvenirs
 - **Example:** Healthcare provider operated sports and fitness center with cardiac rehab, fitness/wellness and roller-skating rink
 - **Example:** Healthcare provider operated sports and fitness center with gym, track, swimming pools, racquetball courts, health resources library, pro shop, and café



PART III

UBTI Exclusions and Examples



Exclusions from UBTI

- Substantially related income (but watch for overly commercial activity... see end of presentation)
- Passive income (but watch for debt-finance limitations)
 - Interest and dividends
 - Rent from real property
 - Income from the sale of capital assets
 - Royalties
 - Research activities (certain income from research grants or contracts)



Exclusions from UBTI

- Substantially all work carried on by volunteers (e.g., hospital gift shop)
- Convenience of members/employees (e.g., trade show for members; school or hospital cafeteria)
- Donated merchandise (e.g., thrift shop)
- Renting of membership and mailing lists to other 501(c)(3)s
- Distribution of low cost items (e.g., stickers, t-shirts that cost under \$5)



Example 1: Cycling lessons/event space

- Exempt Purpose: Make cycling and academic support available to under-resourced youth
- Organization operates an after-school program that provides instruction and opportunities to compete in cycling, while providing academic tutoring and college counseling, at little or no cost
- Organization plans to offer adult cycling classes priced at market rates, to promote community involvement and raise extra funds
- It also plans to rent out its cycling sheds for private evening events
- What are the potential UBTI issues?



Example 1: Analysis

- Adult cycling classes and event space rentals are likely UBTI
- Organization could consider offering adult cycling classes for public school teachers at a reduced fee, which may not generate UBTI because it is closer to the mission.



Example 2: Shuttle buses

- Exempt purpose: Providing guidance, support, and educational resources for children who have incarcerated parents
- Organization operates a free after-school program providing academic, social, emotional, and mental health support
- Organization also offers round-trip van service to certain prison facilities in the area so that children can visit their incarcerated parents. 50% of the van's time is used for this program.
- The other 50% of the van's time is rented out, for pay, to local public and charter schools that want to take students on field trips of any type.
- Any UBTI issues?



Example 2: Analysis

- Close call as to whether the activity is substantially related to the exempt purpose
- The charitable purpose includes ‘educational’ activities
- But the purpose is specifically focused on families with incarcerated parents
- So do the field trips unrelated to incarcerated family members count as ‘related’ to the charitable purpose?



Example 3: T-shirt sales

- Exempt Purpose: Educating the general public on modern dance techniques
- Organization holds community dance classes at little or no cost and regularly hosts low-cost dance performances
- Organization's logo includes a figure in profile indicative of modern dance
- Organization sells t-shirts with its logo for \$25/each
- What are the potential UBTI issues?



Example 3: Analysis

- Does the sale of logo merchandise further an organization's exempt purpose?
 - In a non-precedential statement, the IRS ruled that logo merchandise sold by a breast cancer charity was substantially related to the organization's exempt purpose because the reproduction of the logo raised awareness about the disease, thus furthering the organization's charitable mission
 - But in *Sierra Club, Inc. v. Comm'r I.R.S.*, the Ninth Circuit Court of Appeals ruled that income earned was taxable as UBTI because production and sale of logo t-shirts was not fundamental to the Sierra Club's mission.
- The law is therefore unsettled in the area of logo merchandise and UBTI
- To avoid this issue, organizations can consider licensing their logo to a third-party seller and collecting royalties



PART IV

The Commerciality Doctrine and Protecting Tax Exempt Status



Loss of exempt status: The operational test

- If unrelated business activities exceed a certain (undefined) threshold, 501(c)(3) status may be in jeopardy
 - A 501(c)(3) public charity must engage **primarily** in activities that accomplish one or more exempt purposes (this is called the “operational test”)
 - IRS may revoke exemption if “more than an unsubstantial part of its activities is not in furtherance of an exempt purpose.”

OR

- IRS may revoke exemption if charity is found to have a non-exempt purpose (i.e., a commercial purpose as its **primary** purpose)



Earned revenue and the commerciality doctrine

- Product of common law
- An exempt organization may be found to engage in a non-exempt activity when the activity (**even if substantially related**) is classified as commercial in nature.
- An activity may be deemed commercial if it:
 - (1) has a direct counterpart in the for-profit sector; OR
 - (2) is conducted in the same manner/to the same scale as it is by for-profit entities
- So, charging fees and/or selling goods/services can be done by a 501(c)(3) - but only within limits, as the “commercial hue” attracts scrutiny from the IRS



Facts and Circumstances Weighing For and Against “Commercial” Activity

Facts that tend to be “Commercial” Activity

- Sale of goods/services to the public
- Existence of for-profit direct competitors
- Setting prices based on commercial factors
- Promotional material with commercial phrases
- Use of paid advertising
- Standard/commercial hours of business
- Experienced business management
- Paid employees (limited use of volunteers)

Facts that tend not to be “Commercial” Activity

- Only nominal fees or "substantially below cost"
- Reasonableness of entity's financial reserves
- Volunteers only
- Serving only charitable classes



Addressing UBTI

- Not-for-profits with earned revenue must regularly evaluate whether to (1) conduct the income generating activity directly or through a subsidiary and (2) if through a subsidiary, whether the subsidiary should be for-profit or not-for-profit
- When evaluating the above questions, tax treatment, liability concerns, the ability to secure adequate capital and the ability to maintain “separateness” between the entities should be considered



Conclusions

- A 501(c)(3) charity may engage in activity that generates revenue, but the revenue may be taxable if unrelated to organization's charitable purpose
- May be subject to “unrelated business taxable income” for revenue derived from a trade or business that is regularly carried on and not substantially related to the organization's tax-exempt purpose
- A 501(c)(3) organization cannot have its primary purpose engaging in commercial activity even if related to charitable purpose.



Questions?

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