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Basics of the Federal Unrelated Business Income Tax on Nonprofits

Nonprofits often want to explore ways to increase revenue while carrying out their charitable activities. Before launching a new revenue generating activity, you should make sure you understand how the unrelated business income tax (“UBIT”) might impact your proposed venture. This alert is intended to provide basic information about UBIT for those who are unfamiliar with its application.

UBIT is a federal tax applicable to charitable nonprofits under 501(c)(3) and 501(c)(4) of the Internal Revenue Code.¹ While nonprofits *can* engage in some profit-making activities without jeopardizing their tax-exempt status, there are limitations. The general purpose of UBIT is to stop unfair competition between tax-exempt nonprofit organizations and for-profit companies.² A nonprofit activity might be subject to UBIT if it is an “unrelated trade or business,” or: (1) a trade or business that is (2) regularly carried on and (3) is not substantially related to furthering the exempt purpose of the nonprofit.³

A “trade or business” includes the sale of goods or performance of services carried on with the purpose of producing profit.⁴

A trade or business is considered to be “regularly carried on” if it is conducted frequently or continuously—a helpful frame of reference is if the revenue-generating activity is held with a similar consistency as a non-exempt organization conducting the same activity.⁵ Even a sporadic activity may be considered “regularly carried on” if a commercial organization would conduct the activity in a similar manner, or if sales for the activity are “systematically and consistently promoted.”⁶ A one-off bake sale, for example, would not be “regularly carried on” and therefore not subject to UBIT.

For a trade or business to be “substantially related” to an organization’s exempt purpose (and therefore not susceptible to UBIT), it must have a “causal relationship to the achievement of exempt purposes.”⁷ 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.⁸

Overall, if an activity satisfies all three of these components, the income derived from the activity may be treated as unrelated business taxable income (“UBTI”) if it exceeds a certain threshold.

¹ I.R.C. § 511.

² Jeffrey S. Tenenbaum, *UBIT: A Comprehensive Overview for Nonprofits*, 34 TAX’N OF EXEMPTS 04, July/Aug. 2022.

³ Treas. Reg. § 1.513-1.

⁴ I.R.C. § 513(c).

⁵ Treas. Reg. § 1.513-1(c).

⁶ Treas. Reg. § 1.513-1(c).

⁷ Treas. Reg. § 1.513-1(d).

⁸ Treas. Reg. § 1.513-1(a).

Examples of Activities that May Incur UBIT

Several examples of activities that may subject a nonprofit to UBIT are listed below:

- **Debt-Financed Rental Income.** While rental income is generally not considered taxable under the UBIT rules, rent derived from debt-financed property (e.g. there is mortgage on the property) is likely taxable.⁹
- **Advertising.** Payments made to a tax-exempt organization for advertising a corporate sponsor's products or services are likely subject to UBIT.¹⁰ Nonprofits should therefore be aware of potentially incurring UBTI when entering into a corporate sponsorship arrangement that includes marketing or advertising responsibilities.¹¹
- **Sale of merchandise that does not further the exempt organization's 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.¹² But in *Sierra Club, Inc. v. Comm'r I.R.S.*, a Ninth Circuit Court of Appeals decision, the court used different reasoning.¹³ That court found that if the Sierra Club sold T-shirts with its logo, the 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 UBIT.
 - Another merchandise example can be found in the art museum gift shop context. There, each item must be evaluated as to whether or not it triggers UBIT. Sales of reproductions of the museum's art collection, for example, are unlikely to trigger UBIT because the art reproductions serve to educate the public about the collection itself. By contrast, sales of reproductions of famous locations (e.g. the Statue of Liberty) from the city in which the museum is located likely trigger UBIT because such locations are not directly related to the art museum's charitable mission.¹⁴

UBIT Exceptions and Exclusions

There are a number of exceptions to the UBIT rules and exclusions from the definition of an unrelated trade or business. First off, income earned from most "passive" activities (known as "passive income") is not treated as UBTI. Passive activities are trade or business activities in which the nonprofit does not materially participate. The passive income exclusions include:

- **Rental Income.** As noted above, rental income on property owned outright (not debt-financed) is not subject to UBIT.¹⁵

⁹ I.R.C. § 514.

¹⁰ See <https://www.irs.gov/charities-non-profits/advertising-unrelated-business-taxable-income-and-3rd-party-contractor-issues>.

¹¹ J.J. Harwayne Leitner, Nonprofit Organizations Need Nonprofit Lawyers, 2016 Bus. L. TODAY 1 (2016).

¹² I.R.S. PLR 200722028.

¹³ *Sierra Club Inc. v. Commissioner I.R.S.*, 86 F.3d 1526 (9th Cir. 1996).

¹⁴ See DEPT. TREASURY, PUBLICATION 598 TAX ON UNRELATED BUSINESS INCOME OF EXEMPT ORGANIZATIONS (2021).

¹⁵ I.R.C. § 512(b)(3).

- **Investment Income.** Dividends, interest, annuities, and payments with respect to security loans are excluded from UBTI.¹⁶
- **Royalties.** Income generated from a licensee, related to the use of a valuable right such as a trademark, trade name, or copyright, is not subject to UBIT.¹⁷ For example, in the *Sierra Club* case referenced above, the court found that if the Sierra Club had created the logo designs and licensed those designs to a T-shirt manufacturer in exchange for a fee, the income generated would have been tax-free.¹⁸
- **Research Income.** Certain income from research grants or contracts, depending on the nature of the organization and the type of research, is excluded from UBTI.¹⁹

In addition, the following activities are excluded from being classified as an unrelated trade or business:

- **Work Performed by Volunteer Labor.** When *substantially all* of the work in carrying on a certain activity is performed without compensation, such activity is not deemed to be an unrelated trade or business and therefore not susceptible to UBIT.²⁰
- **Convenience of Members.** A trade or business of a nonprofit specifically serving members, students, patients, officers, or employees of the organization (such as an employee cafeteria) is not deemed to be an unrelated trade or business.²¹
- **Selling of Donated Merchandise.** A trade or business that consists of selling donated goods, such as a thrift shop operation, is not an unrelated trade or business of the nonprofit operator.²²

Private Letter Rulings

A nonprofit may submit a written request to the IRS if it is unsure whether its income-generating activity is subject to UBIT. These responses, called private letter rulings (“PLRs”), are specific to the taxpayer and cannot be considered precedential. While this may seem like an attractive solution, given the complexities of the law and vagueness of determining whether an activity is “substantially related” to an organization’s exempt purposes, PLRs are procedurally difficult to submit and quite expensive. For nonprofit organizations, there is an attached fee. For organizations with gross income less than \$250,000, the fee is \$3,000. That fee becomes \$8,500 for nonprofits with a gross income equal to or greater than \$250,000 but less than \$1 million. For more information on how to submit a PLR, please visit: https://www.irs.gov/irb/2022-01_IRB.

As a practical matter, most organizations can determine if they are subject to UBIT by consulting with their accountant and an attorney, as needed.

¹⁶ I.R.C. § 512(b)(1).

¹⁷ I.R.C. § 512(b)(2).

¹⁸ See https://www.americanbar.org/groups/business_law/publications/blt/2021/11/ubit/.

¹⁹ I.R.C. § 512(b)(7)–(9).

²⁰ I.R.C. § 513(a)(1).

²¹ I.R.C. § 513(a)(2).

²² I.R.C. § 513(a)(3).

Tax Filings Related to UBTI

UBIT is currently imposed as a 21% flat tax rate for nonprofit corporations.²³ Generally speaking, an organization with over \$1,000 of UBTI must file a Form 990-T, and if it expects tax owed to be more than \$500, it must pay the estimated taxes.²⁴

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Elizabeth Wytock at ewytock@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit <http://www.lawyersalliance.org/becoming-a-client>.

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²³ 2021 IRS Instructions for Form 990-T, <https://www.irs.gov/pub/irs-pdf/i990t.pdf>.

²⁴ 2021 IRS Instructions for Form 990-T, <https://www.irs.gov/pub/irs-pdf/i990t.pdf>.