Unrelated Business Income Tax
Old and New Traps for the Unwary

Tuesday, June 25, 2019
Part One

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Agenda

Part I

- Identifying Unrelated Business Income (UBI)
- Exceptions to UBI
- New UBI silo-ing rules
- Reporting and paying UBIT

Part II

- New UBIT rules on parking and commuter benefits
What is Unrelated Business Income?

Unrelated Business Income (UBI)

- Do 501(c)(3) nonprofit organizations have to pay income tax?
  - Generally, no.
  - But income from activities that are not related to the organization’s exempt purposes are subject to unrelated business income tax (UBIT)

- Too much unrelated activity could jeopardize 501(c)(3) status
  - How much is too much?
UBIT Overview

- **IRC §511**
  - *Tax imposed* on income generated from any "unrelated trade or business" conducted by a 501(c)(3) tax-exempt organization
    - *Unrelated Business Income* (UBI)
    - Income taxed at corporate income rates or trust rates, depending on form (current corporate rate: 21%)

- **Why UBIT?**
  - To prevent unfair competition with for-profit entities

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It All Started With Macaroni

VS.

IRS
Three Elements of UBI

Income from:
(must meet ALL three requirements)

1. A trade or business
2. Regularly carried on
3. Not substantially related to the organization’s exempt purpose

(IRC §511(a)(1))

Three Elements of UBI

1. A trade or business
(26 CFR §1.513-1)

- Any activity carried on for the production of income from the sale of goods or the performance of services
  - No exception simply because the activity is carried on within a larger group of exempt purpose activities
- Characteristics
  - Key: Profit motive (Treasury Reg. 1.183-2(b))
  - Commercial manner
  - Unfair competition
  - Extensive use of organization resources
Three Elements of UBI

1. A trade or business
   (26 CFR §1.513-1)

   Profit Motive Test – Reg. 1.183-2(b)
   ▪ Manner in which the activity is carried on
   ▪ Expertise of taxpayer and advisors
   ▪ Time and effort expended
   ▪ Expectation that activity assets will appreciate
   ▪ Success experienced in carrying on the activity
   ▪ History of income or losses
   ▪ Amount of profit earned
   ▪ Financial status of the taxpayer
   ▪ Elements of personal pleasure or recreation

Three Elements of UBI

2. Regularly carried on
   (26 CFR §1.513-1)

   ▪ Look at the frequency and continuity of the activity
     - For as often and as long as if operated by a for-profit?

   ▪ Factors to consider:
     - Year-round?
     - Seasonally?
     - Infrequently or intermittently?

   ▪ Annual fundraising event is not regularly carried on
     - Treas. Reg. 1.513-1(c)(ii)
Three Elements of UBI

2. Regularly carried on
(26 CFR §1.513-1)

Example #1: Is the CAA’s activity “regularly carried on”?

- A nonprofit CAA holds a community resource fair twice a year that is open to the public. At the fair, the CAA sets up a small booth displaying & selling t-shirts, mugs, and bags bearing the CAA’s name.
- A nonprofit CAA decides to turn its employee parking lot into a commercial lot on the weekends to generate additional income.

Three Elements of UBI

3. Not substantially related to the organization’s exempt purpose (26 CFR §1.513-1)

- **Relationship**: What is the relationship of the activity to the accomplishment of the organization’s exempt purpose?
  - Does it contribute importantly to accomplishing that purpose (other than providing financial support)?
  - Consider the size and extent of the activity
  - Simply using income to support exempt purpose does not make the business “related”

- **Sale of products resulting from performance of exempt function not unrelated**
  - If sold in substantially the same condition as it was in when it was created (26 CFR 1.513-1(d)(4)(ii))
Three Elements of UBI

3. Not substantially related to the organization’s exempt purpose (26 CFR §1.513-1)

Example #2: Is the CAA’s activity “substantially related to its exempt purpose”?

- A nonprofit CAA whose mission includes providing job training for unemployed residents operates a grocery store. The store charges prices substantially lower than those charged by competing grocery stores and provides free grocery delivery service to needy residents. The store is operated by a staff of employees experienced in the retail food industry. The store also offers a training program for unemployed residents, including lectures and on-the-job training. The CAA uses four percent of the store’s earnings to fund this training program.

Exceptions to UBIT
Key Exceptions to UTB
Activities not considered an “unrelated trade or business”

Volunteer Exception (IRC §513(a)(1))
- Substantially all of the work is performed by volunteers without pay

Convenience Exception (IRC §513(a)(2))
- Activities conducted for convenience of members, students, employees

Donated Goods Exception (IRC §513(a)(3))
- Substantially all merchandise sold has been donated (e.g., thrift shop)

Example #3
- A nonprofit CAA operates a retail store selling items to the general public.
- What if…a CAA employee manages the store, but the other 5 people working at the store are volunteers?
- What if…the store only sells used clothes, books, and furniture that have been donated to the CAA in order to benefit the organization’s programs?
Key Exclusions from UBI
Activity considered an “unrelated trade or business” but income from activity NOT taxable to organization

“Passive” Investment Income (IRC §512(b)(1) & (5))
- Dividends, interest, royalties, rents from real property, annuities
- Capital gains from sale of stock or property

Qualified Sponsorship Payments (IRC §513(i)(1))
- No arrangement or expectation of “substantial return benefit” other than the use or acknowledgment of name/logo/product

UBIT Pitfalls: Exceptions to the Exceptions
Counts as UBI and Subject to UBIT

- Rent from debt-financed property
  - Unless substantially all of the use (85%) of the property is substantially related to exempt purpose

- Interest, annuities, royalties, rents from taxable controlled entities
  - For example, a subsidiary corporation owned by the nonprofit CAA

Tax-Exempt Parent
- Interest, annuities, royalties, rents = UBI

Dividend ≠ UBI

Controlled Taxable Subsidiary
- Dividend
Example #4
- A nonprofit CAA forms a subsidiary (a C-corporation) to run a for-profit catering business. The CAA is the sole stockholder of the subsidiary. The catering business transfers the income it generates to the parent CAA in the form of dividends.

Example #5
- A nonprofit CAA rents out part of its office building. It charges rent to tenants whose activities are unrelated to the organization’s exempt purpose.
- What if...there is a mortgage on the building?
- What if...the tenant occupies the first floor of a 12 story building?
Advertising vs. Sponsorship

- **Qualified Sponsorship Payment**
  - A *qualified sponsorship payment* is not advertising and not subject to UBIT
    - Example: Acknowledging a sponsor in a conference program book
  - **Not UBI** so long as:
    - The sponsorship doesn’t include price information or try to sell any services or products
    - OK to include the sponsor’s name, address, phone number, website, logo
    - OK to include general description of a product

New UBI Silo-ing Rules
Reporting UBI for Each Trade or Business

- **Prior law**
  - Calculate UBI by aggregating gross income from all unrelated business activities
  - Then subtract aggregate deductions

- **New law**
  - Must determine UBI separately for each trade or business
  - An unrelated trade or business’s income can only be offset by deductions directly connected with that particular trade or business

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**Example:** Nonprofit CAA operates 3 social enterprises

<table>
<thead>
<tr>
<th>Social Enterprises</th>
<th>Gross Income</th>
<th>Allowable Deductions</th>
<th>UBTI (New Law)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cleaning enterprise</td>
<td>$10,000</td>
<td>$15,000</td>
<td>$0</td>
</tr>
<tr>
<td>Catering business</td>
<td>$25,000</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Weatherization business</td>
<td>$15,000</td>
<td>$10,000</td>
<td>$5,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$50,000</strong></td>
<td><strong>$35,000</strong></td>
<td><strong>$20,000</strong></td>
</tr>
</tbody>
</table>

- **New law:** UBI = $20,000 ($0 + $15,000 + $5,000)
- **Prior law:** UBI = $15,000 ($50,000 - $35,000)
Reporting and Paying UBIT

Federal filing requirement: Form 990-T
- Must file Form 990-T if organization generates more than $1,000 in *gross income* from unrelated trade or business
  - Even if organization ultimately owes no tax because of permissible deductions or tax credits
- Must file by 15th day of 5th month after organization’s tax year
  - Can request automatic six-month extension
- Form 990-T must be made available for public inspection

Check state laws and filing requirements
UBIT Tax Rate

- **UBIT tax rate**
  - Apply rate for the legal form of entity (e.g., corporate rates for corporation; trust rates for trusts, etc.)
    - Current corporate rate = 21%

- **Can take ordinary and necessary deductions**
  - Directly connected to the operation of the activity

Filing Quarterly Estimated UBIT

- CAAs that expect to owe more than $500 in UBIT must make quarterly estimated tax payments
  - Due April 15, June 15, September 15, and December 15
  - Use Form 990-W to calculate quarterly estimated tax payments
UBIT Takeaways

- **Purpose is to prevent unfair competition**
  - Consider whether activity competes with for-profit

- **If activity is unrelated and taxable, but insubstantial**
  - Activity may still be worthwhile to undertake

- **If activity is unrelated, taxable, and substantial**
  - Be sure activity is not conducted on a scale that threatens exempt status

- **File quarterly estimated UBIT if expecting to owe > $500 in UBIT**