A Guide to Unrelated Business Income

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For today's tax-exempt organizations, compliance with unrelated business income tax regulations is critical. Though the Internal Revenue Service continues be active in this area, state governments are becoming more active in addressing compliance. Understanding the current regulatory climate and tax laws is the first step in the process of minimizing potential risk associated with noncompliance.

To properly assess unrelated business income (UBI) activities, exempt organizations must understand both the basic and advanced issues of compliance. For an activity to be classified as unrelated, it must be a trade or business, regularly carried on, and not substantially related to the organization's exempt purpose.

A trade or business includes any activity that is carried on for the production of income. The activity may be conducted as a standalone activity or within a larger group of similar activities. In addition, the activity may be conducted directly by the organization or indirectly through a partnership or limited liability company. A key attribute of a trade or business is the existence of a profit motive, not whether the activity itself is profitable.

Income from an activity will not be classified as UBI unless it is regularly carried on. To determine whether a trade or business is "regularly carried on," it is necessary to address the frequency and continuity of the activity. Typically, activities that are carried on intermittently or sporadically are not considered to be regularly carried on unless the activity is conducted in a manner typical of for-profit organizations.

A trade or business is considered unrelated if it is not substantially related to the organization's exempt purpose. The activity itself must contribute importantly to the accomplishment of the exempt purpose of the organization. The fact that the activity provides funds to support the organization's exempt purpose is not enough to meet the "substantially related" test.

Exclusions

There are certain specific exclusions from unrelated business income. When these exclusions do apply, the income is automatically excluded from the calculation of unrelated business taxable income. The exclusions include income from activities where substantially all work is performed by volunteers or sales of merchandise, substantially all of which has been donated to the organization. Activities carried on by 501(c)(3) organizations and conducted primarily for the convenience of its members, students, patients, or employees are also excluded UBI.

Income derived from qualified convention or tradeshow activities conducted by associations may also be excluded from UBI, provided the activities are of the nature typically conducted at conventions, annual meetings, and so forth. Specifically, the exempt purpose of the organization must be the primary purpose of the convention. Passive income such as dividends, interest, royalties, annuities, security lending, and capital gains and losses from the disposition of property (other than property used in an unrelated trade or business) are also specifically excluded from UBI. Income from the rental of real property is exempt. However, the real property exclusion does not apply if the income is generated from property subject to acquisition indebtedness.

Qualified Sponsorship Payments

Qualified sponsorship payments received by an organization are exempt from unrelated business income tax. A QSP is a payment of money, transfer of property, or performance of services by any person with respect to which there is no expectation that the person will receive any substantial return benefit. A substantial return benefit would include advertising, exclusive provider arrangements, provision of goods or services, and other privileges in exchange for the sponsorship payment.

Substantial return benefit specifically excludes a disregarded benefit or acknowledgment of the sponsorship payment. A benefit will be disregarded if the aggregate fair market value of all the benefits provided to the sponsor in exchange for the payment is not more than 2 percent of the amount of the payment. If the aggregate fair market value of the benefits exceeds 2 percent of the payment, the entire fair market value of the benefits is a substantial return benefit.

A substantial return benefit excludes an acknowledgment of the sponsorship arrangement. The acknowledgement may include

- the sponsor's name
- logos and slogans that are part of the sponsor's identity and do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities, or company
- a list of the sponsor's locations, telephone numbers, or internet address
- value-neutral descriptions of the sponsor's product line or services
- the sponsor's brand or trade names and product or service listings.

For the purpose of substantial return benefit, advertising is always deemed to be substantial return benefit and taxable as unrelated business income.

Royalties, Rents, and More

Royalties are generally excluded from unrelated business income as long as the exempt organization is passive and not active in generating the income. The IRS has been actively challenging the passive versus active positioning of royalty income earned by exempt organizations. If an exempt organization renders services under the royalty agreement, the income may no longer be passive.

Income from the rental of real property is generally excluded from unrelated business taxable income. The exclusion is not available if the amount of rent depends in whole or part on the income or profits derived from the property, other than a fixed percentage of gross receipts or sales. Payments for the use or occupancy of rooms and other space where services are also rendered by the exempt organization do not represent rent from real property.

Income derived from a controlled organization is treated as unrelated business income. For this purpose, control is defined as ownership, by vote or value, of 50 percent of the stock of a corporation, profit or capital interest, or beneficial interest. The earlier exclusion from UBI for interest, royalties, or rents does not apply when the payment is from a controlled organization.

Compliance with unrelated business income regulations does not stop with the identification of revenue sources. The allocation of expenses associated with UBI activities is equally important. With the IRS challenging expense allocations and net operating loss carryovers, the documentation of the methodology used in the allocation of direct or indirect expenses is critical should the organization find itself in an audit.

For today's exempt organizations, understanding the current regulatory climate and tax laws is required to minimize any potential risk associated with UBI noncompliance. With the current IRS initiatives and increased scrutiny by state governments, exempt organizations must be actively monitoring UBI compliance.

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