

MAKING UBIT A BITE YOU CAN LIVE WITH

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Critical legal and tax considerations apply to earned income ventures that must be taken into account when planning and managing them. Such ventures must also be structured to protect the charitable organization's tax-exempt status. Care should also be exercised to minimize the tax on Unrelated Business Income.

This article highlights important legal rules that govern the conduct of earned income activities by organizations that are exempt from federal income taxes. For these purposes, it is assumed that the reader understands the criteria for recognition and maintenance of tax-exempt status.

UBTI is defined as the "gross income derived by an organization from any unrelated trade or business regularly carried on by it." IRC § 512. An "unrelated trade or business" is any trade or business the conduct of which is not substantially related, aside from the need of such organization for income or funds or the use it makes of the profits derived, to the exercise or performance by such organization of its exempt function. IRC § 513. Exempt organizations pay tax UBTI. Generally, tax is imposed on UBTI, known as Unrelated Business Income Taxation or UBIT.

When unrelated business activity constitutes a substantial part of the organization's activities, its tax-exemption may be jeopardized. Although the IRS has never stated a specific rule as to how much UBTI is too much, a good rule of thumb is that 10% to 15% of gross revenues, or 10% to 15% of the organization's overall activities, without regard to revenues generated, is an acceptable level. However, there have been cases at both extremes with unexpected results.

To determine whether UBTI exists, an exempt organization needs to address each of the following concerns:

1. Does the activity constitute a **Trade or Business**. does it have characteristics of a business? Is the nonprofit's "primary purpose for engaging in the activity [] for income or profit." *Comm'r v. Groetzinger*, 480 U.S. 23, 25 (1987).
2. Is the activity Regularly Carried On? IRS regulations require the an analysis of whether the trade or business activities "manifest a frequency and continuity, and are pursued in such a manner, generally similar to comparable commercial activities of nonexempt organizations." Treas. Regs. § 1.513-1(c)(1).
3. Is the conduct of the trade or business **Substantially Related** to the organization's tax exempt purpose? Does it have a substantial causal relationship to the achievement of the exempt purposes or does it "contribute importantly to the accomplishment of those purposes." Treas. Reg. § 1.513-1(d)(2).

There are various principles that can be used to assess whether unrelated business contributes importantly to accomplishment of exempt purposes, including:

- a. Is the size and extent of the activity conducted on a larger scale than reasonably necessary for the performance of such functions?

- b. Are products produced from the performance of exempt functions sold in substantially the same state as upon completion of the exempt function?
 - c. Gross income derived from the performance of exempt functions is not gross income from an unrelated trade or business.
 - d. Gross income derived from unrelated business activities of dual use facilities is income derived from an unrelated trade or business.
 - e. Gross income generated from the exploitation of good will and other intangibles is income derived from unrelated business income.
4. Does the organization provide management services to other exempt organizations? Unless the other organizations are related or the services are provided substantially below cost, income derived from such services is UBTI.

There are a number of statutory exceptions and modifications to UBTI, even if the activity would otherwise constitute UBTI:

1. Businesses in which "substantially all the work in carrying on such trade or business is performed for the organization without compensation." IRC § 513(a)(1).
2. When the trade or business is carried on "primarily for the convenience of its members, students, patients, officers or employees."
3. The business "engaged in the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions." IRC § 513(a)(3).
4. Passive income such as dividends, interest, royalties, annuities, etc., where the nonprofit provides no services to the provider of the passive income. IRC § 512(b).
5. Rents from real property (including personal property leased with the real property) but not when services are provided to the lessee and not where the rent is determined by the lessee's income or profit. The exception from UBTI is limited to the portion of real property that is not debt-financed.
6. There are a number of other modifications in Code § 512 that may be applicable, depending on the characteristics of a particular organization. For example, UBTI does not apply to unrelated income generated by religious orders in certain circumstances. *See* IRC § 512(b)(15).

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