



VENABLE



UBIT: The Most Important Things Your Nonprofit Needs to Know

Speakers

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Agenda

- Introduction and History
- Trade or Business
- Regularly Carried On
- Relationship to Mission
- Gift Shops
- Rental Income
- Advertising/Sponsorships
- Conventions/Trade Shows
- Contractual Services
- Royalties
- Exceptions



Unrelated Business Income

What's Wrong with Making a Profit?

- Unrelated Business Income is taxed @ corporate rates (avg. 40% blended fed and state), leaving the organization with roughly 60% of after-tax profits
- Alternative Revenue Generating Activities, in aggregate, should not become a substantial part of the organization's activity
- Understanding the tax consequences of proposed transactions helps the organization make sound business decisions



Unrelated Business Income

IRS Examination Risk

- Colleges and Universities Project—Concluded in 2013
 - Evidence of noncompliance particularly with regard to UBIT and expense allocation
 - Colleges often reported significant unrelated business income, but usually reported a loss on underlying activities
 - IRS questioned the validity of those losses and whether they were attributable to the unrelated activity
 - IRS stated it plans to implement enforcement (beyond just colleges and universities) as a result of the findings
- Service has engaged in increased examination activity for organizations that report activities that result in three consecutive years of losses



Unrelated Business Income

Federal

- Form 990-T, Unrelated Business Income Tax Return, when gross receipts from an unrelated business are \$1,000 or more
- Form 990-T is available for public inspection (501(c)(3) organizations only)

State

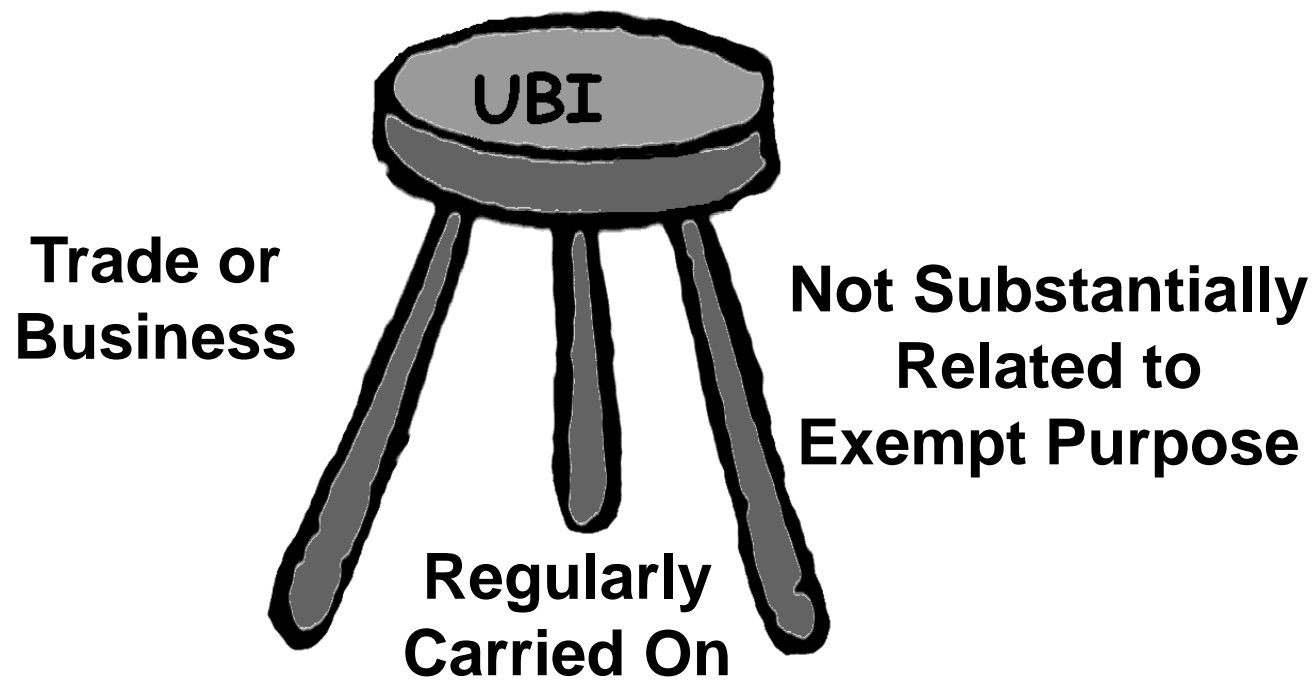
- Certain states impose a tax on UBI generated
- Additional tax filings may be required

Penalties

- Failure to file
- Failure to pay estimated tax payments
- Late payment of tax
- Interest



UBI Defined – IRC § 512(a)(1)





Trade or Business Reg. §1.513-1(b)

Activities carried on for the production of income from the sale of goods or the performance of services

- 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
- Unfair Competition Test
- Commercial Manner Test



Regularly Carried on Reg. §1.513-1(c)

- Are the activity's frequency, continuity, and manner of conduct comparable to commercial operations of similar for-profit organizations?
 - Annually?
 - Quarterly?
 - Intermittently?
 - Sporadically?



Not Substantially Related Reg. §1.513-1(d)

- What is the relationship of the activity to the accomplishment of the exempt purpose (other than the destination of income)?
- What are the size and extent of the activity in relation to the nature and extent of the exempt function that they purport to serve? Is it excessive?



Not Substantially Related Reg. §1.513-1(d)

Dual-use activities

- The exempt purpose of Charity X is to improve the quality of life for individuals suffering from Disease X
 - Charity X maintains a vaccine manufacturing facility
 - Facility manufactures vaccines to treat Disease X
 - Facility also manufactures vaccines to treat Disease Y



Not Substantially Related Reg. §1.513-1(d)

Exploitation of an exempt activity

- The exempt purpose of Charity X is to improve the quality of life for individuals suffering from Disease X
 - Charity X maintains a vaccine manufacturing facility
 - Facility manufactures vaccines to treat Disease X
 - Facility also manufactures vaccines to treat Disease Y



Not Substantially Related Reg. §1.513-1(d)

An organization (whose purpose was to provide job training for unemployed residents) in a poor neighbourhood operated a food service business at prices substantially lower than those charged by competing grocery stores, provided free grocery delivery service to needy residents, and provided job training for unemployed residents. About four percent of the store's earnings is allocated for use in a continuous training program for the local chronically unemployed.



Substantially Related Reg. §1.513-1(d)

Organization formed to provide therapy for emotionally disturbed adolescents operates a grocery store that employs therapy patients. The grocery store is operated at a level to utilize only the number of adolescents residing at the facility. The development of job skills is secondary to the goal of emotional rehabilitation of the adolescents through job satisfaction and personal achievement.



Gift Shops

Red State Zoo Gift Shop

1. T-shirts with animal pictures
2. T-shirts with animal pictures and a pamphlet describing the zoo's efforts to preserve that animal species and habitat
3. Postcards and calendars of zoo animals
4. Postcards of the Red State City skyline
5. Camera film and batteries
6. Newspapers
7. Snack bar
8. Sale of items on the website
9. Gift wrapping
10. Stuffed animals



Rental Income

- An exempt organization rents out a large portion of its office building. It charges rent to tenants whose activities are unrelated the organization's exempt purpose.
- There is a mortgage on the building.
- The tenant occupies the first floor of a 12-story building.




Rental Income – When It Is Taxable

- Property is debt financed
- Tenant is a controlled corporation
- Based on a percentage of the tenant's net income
- Includes payment for services
- >50% is attributable to personal property
- Lessor is a social club, VEBA, or SUBT



Rental Income – Acquisition Indebtedness

- Acquiring the property
- Improving the property
- Incurred prior to acquisition/improvement, but would not have been incurred but for the acquisition/improvement
- Reasonably foreseeable debt
- Exception: property subject to mortgage, acquired by gift or bequest



Rental Income – Planning Tip

- Subdivide the property into its exempt-purpose portion and its rental portion
- Apply cash down payment to the rental portion
- Accelerate payments on the rental portion
- Exempt-purpose portion generates no taxable income regardless of leverage



Rental Income – Parking Facilities

- A tax-exempt organization owns a parking garage used by the general public and charges an hourly fee
- A tax-exempt hospital owns a parking garage, used by employees, physicians, patients, and visitors, and charges an hourly fee
- The hospital leases the parking lots during non-business hours to local businesses, and charges an hourly fee
- A tax-exempt organization leases the parking garage to a third-party operator



Advertising

Reg. §1.513-4(c)(2)(v)

Advertising Defined

Any message or material that promotes or markets any trade, business, service, facility, or product using:

- Qualitative or comparative language
- Price information or other indications of savings or value
- Endorsements
- Inducement to purchase, sell, or use any company, service, facility, or product.

A single message that contains both advertising and an acknowledgment is advertising.



Qualified Sponsorship Payment

IRC 513(i)

QSP Defined

A payment made by a trade or business where there is no arrangement or expectation of any substantial return benefit other than the use or acknowledgment of the name, logo, or product lines of such trade or business. A QSP does NOT include:

- Qualitative or comparative language
- Price information or other indications of savings or value
- Endorsements
- Inducement to purchase, sell, or use any company, service, facility, or product



Qualified Sponsorship Payment

Reg. 1.513-4(c)(2)(iv)

Permissible QSP Acknowledgment

- Exclusive sponsor arrangement
- Name, address, phone number, website, logo
- General description of the product line (“retailer of fine bathroom fixtures”)
- Visual depictions of the products and services
- Taglines (“The Ultimate Driving Machine”)
- Display or distribution of products



Qualified Sponsorship Payment

Reg. 1.513-4(c)

QSP Defined

A QSP also does NOT include:

- Exclusive provider arrangement
- Goods, facilities, services, or privileges
- Right to use exempt organization's logo, trademark, patent, etc.
- Payments contingent on exposure
- Periodicals and trade shows

De minimis benefits can be disregarded



Advertising That Is Not Regularly Carried On

NAT. COLLEGIATE ATHLETIC ASSN. v. COMM., 66 AFTR 2d 90-5602

- 129 pages
- Articles on New Orleans, Patrick Ewing, Michael Jordan, prior tournaments, and the four schools
- 35% ads, \$56,000 of ad revenue on gross receipts of \$18.7M
- Nike, McDonald's, Coca-Cola, Miller, ESPN, Texaco, Xerox



Advertising That Is Not Regularly Carried On

NAT. COLLEGIATE ATHLETIC ASSN. v. COMM., 66 AFTR 2d 90-5602

- NCAA: Advertising is not UBI because the tournament is not regularly carried on
- IRS: The advertising is carried on during the entire tournament, which is the only “season” that matters
- Tax court: The advertising activity occurs all year long, including soliciting orders and preparing the publication



Advertising That Is Not Regularly Carried On

NAT. COLLEGIATE ATHLETIC ASSN. v. COMM., 66 AFTR 2d 90-5602

U.S. Court of Appeals, Tenth Circuit

- *Commercial* advertising is a year-round activity
- The business activity here is not the tournament, which is exempt, but the sale of ads, which is unrelated
- Distribution of programs to spectators occurred for only 3 weeks during the year
- NOT regularly carried on



Qualified Sponsorship Payment

Reg. 1.513-4(f)

A non-commercial broadcast radio station airs a program funded by The Music Shop. Are the following messages advertising?

- "This program has been brought to you by the Music Shop, located at 123 Main Street. For your music needs, give them a call today at 555-1234. This station is proud to have the Music Shop as a sponsor."
- "This program has been brought to you by the Music Shop, featuring the finest selection of music CDs and cassette tapes. This station is proud to have the Music Shop as a sponsor."
- "This program has been brought to you by the Music Shop, located at 123 Main Street, 555-1234, www.musicshop.com. This station is proud to have the Music Shop as a sponsor."



Conventions/Trade Shows

Vendors exhibit products and services and promote public interest in the industry

Income from such activity is excluded from UBI only when the activity is carried on by a qualifying organization in conjunction with a qualified convention or trade show. The purpose of the activity should be educating members, promoting products and services of the industry, or educating persons attending the show concerning new developments or products and services related to the exempt activities.



Conventions/Trade Shows

The Live Forever Foundation conducts a trade show. Exhibitors pay \$5,000 for a booth, and attendees pay \$1,000/person.

The Platinum Sponsor pays \$50,000 and receives:

- Link from website
- Logo on tote bag
- Free booth at the trade show
- 6 admission tickets
- Right to introduce the keynote speaker
- 2 full-page ads in the monthly magazine (FMV of \$4,000/each)

How should the payment be shown on Form 990?



Contractual Obligations

Contracts or other agreements that obligate the nonprofit to perform certain acts or services in exchange for payment

For example, in exchange for a large donation, the nonprofit agrees to encourage its members to use the donor's goods and services, send out letters or emails to its members, monitor and report on results, etc.

Services provided by an exempt organization to a donor can result in a substantial return benefit to the donor without advancing the mission. The organization should make a good-faith estimate of the fair market value of the services it is providing, and consider whether that portion of the payment is exempt-function income or UBI.



Contractual Obligations

\$100,000 License Agreement

Trial Balance/Audited Financial Statements

- Contribution?
- Sponsorship?
- Royalty?



Contractual Obligations

The Save the Whales Foundation signs an agreement with Flyover Country Airlines.

The Foundation will:

- Grant a license to use its trademarks
- Provide a quarterly membership list, including physical and email addresses
- Send an email to its members, promoting the affinity agreement with Flyover
- Insert Flyover's promotional material in its membership renewal notices
- Put Flyover's logo on its homepage, with a hyperlink
- Identify Flyover as the "preferred" airline of the Save the Whales Foundation
- Provide educational content to be featured on Flyover's website



Contractual Obligations

The Save the Whales Foundation signs an agreement with Flyover Country Airlines.

The Airline will:

- Obtain written approval of all promotional material using the trademarks
- Paint the Foundation's logo and a depiction of a humpback whale on the body of 10 planes
- Pay a sponsorship of \$100,000
- Pay the Foundation 1% of all tickets purchased by individuals following the hyperlink from the Foundation's website
- Pay the Foundation 1% of all tickets purchased by members responding to a solicitation from Flyover



Royalty Income

IRC Sec 512(b)(2)

The use of a valuable intangible asset, such as a logo, copyright, trademark, etc., is excluded from UBI with certain exceptions:

- Produced by debt-financed property
- Received from a controlled subsidiary
- Connected to the performance of services

Elimination would raise \$1,800,000,000 of UBIT (JCT estimate)



Royalty Income

IRC Sec 513(h)(1)(B)

- The rental of a mailing list between two public charities is excluded from UBI
- When a nonprofit rents its mailing list to a commercial enterprise or individual, the rules applicable to affinity card income generally apply
- Activity must remain passive
- May be prudent to use a list broker



UBI Analysis

Then look for...

- Exceptions
- Exclusions
- Court cases

But be aware of...

- Exceptions to the exceptions



Exceptions

- University's School of Engineering conducts research projects for commercial companies on a contract basis. The research activity is unrelated to the exempt purpose of the University.
- Charity R conducts research projects for commercial companies on a contract basis. The research activity is unrelated to the exempt-purpose Charity R. The results of the research are timely and adequately made available to the general public.
- Charity R conducts research projects for commercial companies on a contract basis. The research activity is unrelated to the exempt-purpose Charity R. The research is performed for the State of Virginia.



Exceptions

- An exempt orphanage operates a retail store that sells items to the general public.
- An exempt orphanage operates a retail store that sells items to the general public. All of the individuals carrying on the work are uncompensated.
- An exempt orphanage operates a retail store that sells items to the general public. Persons desiring to benefit the organization contribute used clothes, books, and furniture to be sold to benefit the orphanage.



Exceptions

- An exempt assisted-living facility operates a laundry for the benefit of the residents.
- A public charity receives “passive” investment income, including dividends, interest, and royalty income.
- A public charity receives interest on a loan to a controlled taxable subsidiary.
- An exempt organization sells its mailing/membership list to unrelated entities.
- An exempt organization sells its mailing/membership list to unrelated entities and provides support services.



Exceptions

- A 501(c)(3) social welfare organization offers a monthly casino night, using paid volunteers.
- A 501(c)(3) social welfare organization offers a monthly casino night, using unpaid volunteers.
- A 501(c)(3) social welfare organization offers a monthly casino night, using unpaid volunteers who can receive tips.
- A social club or fraternal association offers a monthly casino night, which is open to nonmembers.
- The only game is bingo.
- The only game is “instant bingo” scratch-off cards.



Exceptions

Partnership Income

- Save the Whales (StW), a Section 501(c)(3) organization, is a partner in a partnership. The partnership reports \$5,000 of net ordinary business income and deductions from activities that are unrelated to StW's exempt purpose. The partnership also reports \$500 of interest and dividend income from its own investments. The partnership made a \$4,000 distribution to StW during the year.
 - What gets reported on Form 990-T?
 - What gets reported on Form 990?



Exceptions

S Corporation Income

- Save the Whales (StW), a Section 501(c)(3) organization, is a shareholder in an S Corporation. The S Corporation reports \$5,000 of net ordinary business income and deductions from activities that are unrelated to StW's exempt purpose. The partnership also reports \$500 of interest and dividend income from its own investments. During the year, StW realizes a gain from disposing its S Corporation stock.



UBIT Deductions

Allowable Deductions

- Ordinary and necessary
- Proximate and primary relationship to the business activity
- Related party rules
- UNICAP
- Meals and entertainment
- Fines and penalties
- Excess readership costs



UBIT Deductions

Rensselaer Polytechnic Institute v. Commissioner

The Salamander Museum, an exempt organization, uses its auditorium for 160 days a year for exhibits and seminars related to its mission. Fifty days a year, the auditorium is used for concerts, movies, and other activities unrelated to its mission.

- What portion of the indirect expenses of operating the auditorium are deductible?
 - 50/210?
 - 50/365?
 - Some other allocation entirely?