



UBIT – The Tax Consequences of Revenue-Generating Activities for Your Nonprofit

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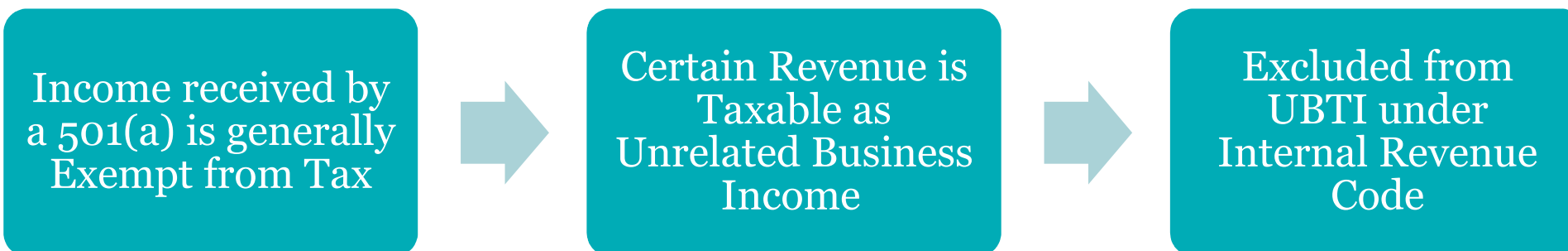
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Analysis of Revenue Generated by a Nonprofit



Roadmap for Today

- Origins of UBIT
- Elements of the 3-prong UBIT Test
- Modifications and Exceptions – and Exceptions to the Exceptions
- Spotlight on:
 - Royalties
 - Advertising and Sponsorships
 - Conventions and Trade Shows
- Recent Developments:
 - SILO Guidance
 - NOLs and the CARES Act
- Form 990-T

Destination of Income Test



As long as the profits support a nonprofit, shouldn't the revenue be tax-exempt?

Internal Revenue Code Sections

Section 511

- Imposes tax on unrelated business taxable income of most organizations described in 501(c)
- Applies standard corporate rates

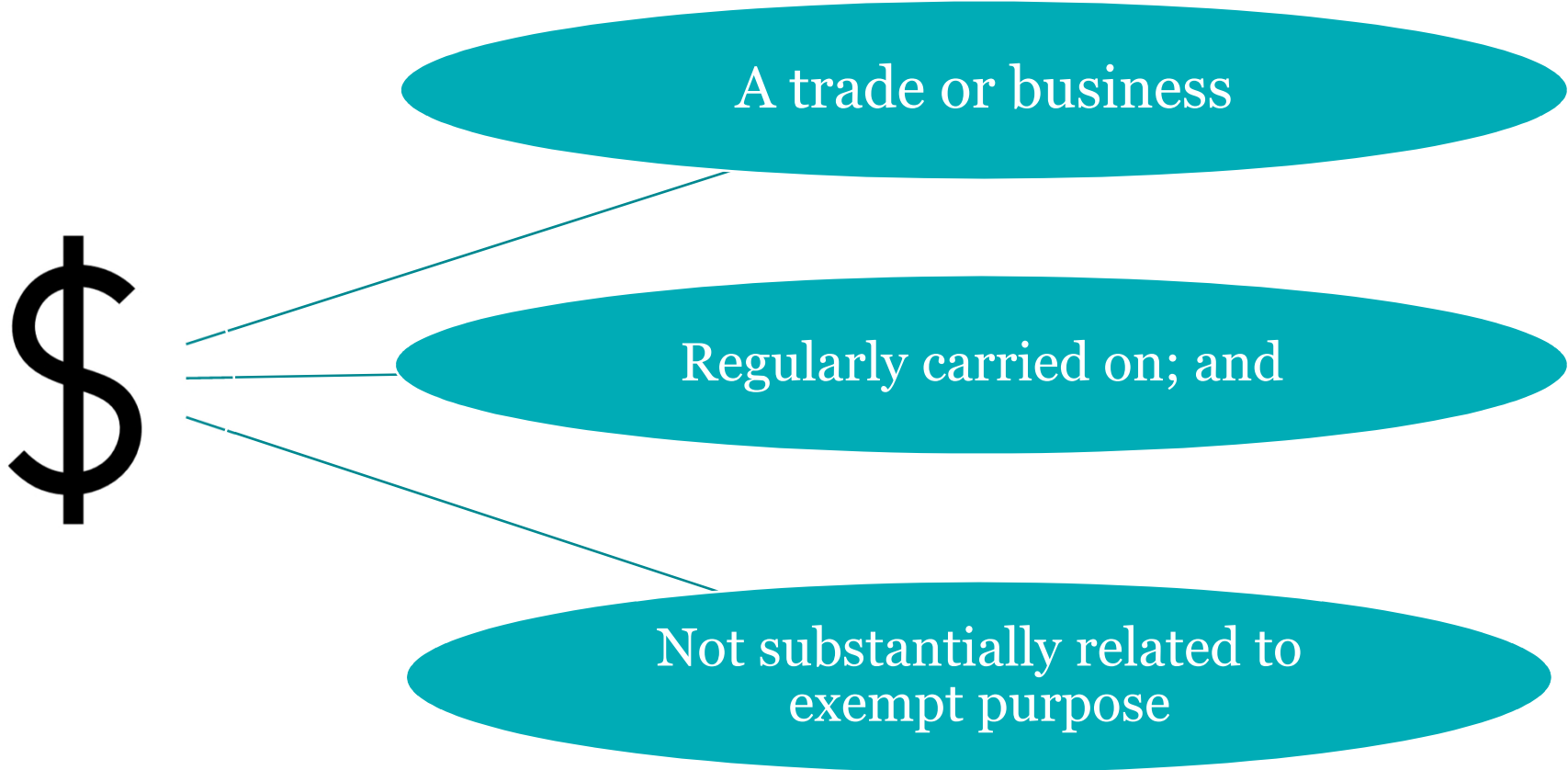
Section 512

- Subsection a: General Rules of Applicability and Test
- Subsection b: Modifications to the General Rules

Section 513

- Exceptions to the Definition of Unrelated Trade of Business

Three-Prong Test



Guiding Principle: Avoid Unfair Competition with For-Profit Businesses

“The primary objective of adoption of the unrelated business income tax was to eliminate a source of **unfair competition**Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.” Treas. Reg. Section 1.513-1(b)

Prong 1: Trade or Business

Any Activity Carried on for the
Production of Income from the Sale of
Goods or Performance of Services

Prong 2: Regularly Carried On

Frequency and Continuity of the Activity

- A Facts and Circumstances Analysis

Prong 3: Not Substantially Related

No substantial causal relationship
between the conduct of the activity
and achievement of exempt purpose

Advertising Income

When is Advertising Income Taxable? Remember the Test

- Regularly Carried On: If activity is not regularly carried on, income generated is not UBTI
 - *Nat. Collegiate Athletic Assn. v. Comm.*, 66 AFTR 2d 90-5602 (10th Cir. 1990)
- Not Substantially Related: Income from advertisements in periodicals or acknowledgments that are paid and bargained for is not substantially related
 - Detailed rules in the Regulations for calculating tax owed, based upon direct advertising costs, advertising income, circulation income, and costs of producing and distributing the periodical

Other Possible Taxable Activities

Based on Recent IRS Enforcement

- Consulting and Management Services: Even if providing for the benefit of other (unrelated) exempt organizations, even if at cost, IRS has determined income is subject to UBIT
- Job-Listing Revenue: Income from employers generally viewed as advertising and taxable; note the IRS has made exceptions for job placement services where there is a demonstrated community need (e.g. P.L.R. 9617040)
- Retail, Food Service, Manufacturing: The IRS focuses closely on the underlying purpose for engaging in the activity; job-training can be legitimate; but see Panera Foundation case

Section 512(b) – Modifications that Exclude Certain Income from UBIT

Investment
Income

Royalties

Rent

Capital
Gains

Research-
Generated
Income

Religious
Services

Section 513 – Per Se Exceptions to “Trade or Business”

Volunteers	Convenience of Members in their Capacity as Members	Contributions	Conventions, Trade Shows, and State Fairs
Bingo	Donated Merchandise	Low-Cost Items with Solicitations	Mailing Lists
Corporate Sponsorships	Hospital Services	Qualified Pole Rentals	Debt Management Services by 501(q)

Royalties

What is a Royalty?

- There is no statutory or regulatory definition
- “Payments for the use of valuable intangible property rights” *Disabled American Veterans v. Commissioner*, 94 T.C. 60 (1990)
- “Payment made to the owner of property for permitting another to use the property, where the property is either an intangible property right or a right relating to the development of natural resources.” *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996).
- Most commonly in the context of trademark license

Outline of a Tax-Free Royalty Arrangement

Name, mark, and Mailing List licensed to a for-profit entity

Third-party Product (e.g. Affinity Credit Card)

No active promotion by the nonprofit

- Announcement letters and quality control measures would not be active: nonprofit can protect its reputation
- Additional service components: would need to quantify and separate payment for those elements and should be insignificant
 - Endorsement or other promotional activities
 - Significant support activities, like sorting lists, or rights to oversee content
 - Evidence of a quid pro quo

Key points on Royalties

Active Management

- The more active the organization is, the more likely it is that IRS will challenge royalty status

Licensor not Manager

- Organization's responsibilities should be limited

Facts Matter

- IRS looks at entire transaction, details matter

Separate Payments

- Bifurcate into two agreements for license and services

Commercial Co-Ventures (CCV)

An arrangement between a charity and a commercial entity under which the commercial entity advertises in a sales or marketing campaign that the purchase or use of its goods or services will benefit a charity or charitable purpose.

- Regulated under state charitable solicitation statutes and laws vary state by state.
- Many states require a written contract, filing requirements, specific advertising disclosures, and detailed record-keeping and compliance

CCV Income and UBIT

If the charity's role is entirely passive, the income from the CCV would be treated as public support income.

However, UBIT may be triggered if the charity:

- Has an active role promoting the CCV
- Provides any return benefit to the co-venturer (including name and logo on charity website in connection with the promotion)
 - Consider a corporate sponsorship or royalty arrangement instead

Corporate Sponsorships

- Qualified Sponsorship Payments are not income from an unrelated trade or business when a trade or business makes a payment to a nonprofit under certain specific conditions.



Corporate Sponsorships: The fine print

No
Substantial
Return
Benefits
Allowed

- The only benefits allowed to the sponsor in return for the sponsorship payments are:
 - The **use or acknowledgment** of the sponsor's name or logo, or
 - A **disregarded benefit** – goods and services with a low value relative to the sponsorship payment

Use or Acknowledgment

Allowed:

- Logos and slogans
- Contact Information
- Displays of Products or Depictions of Services
- Product Lists, Brands List
- Exclusive Sponsor

Not Allowed:

- Qualitative or Comparative Language
- Price Information or Statement of Value
- Endorsements
- Inducement to Buy
- Exclusive Provider

Disregarded Benefit

Benefits are disregarded if:

- The aggregate fair market value of all the benefits provided to the sponsor, other than use or acknowledgment benefits, are not more than 2% of the amount of the payment. A safe harbor for some advertising
 - If the 2% threshold is exceeded, then the entire fair market value of the benefit is a substantial return benefit, not just the excess

Conventions and Trade Shows

These activities are excluded from the definition of Unrelated Trade or Business when the event, through the character of exhibits and extent of industry products displayed:

- Promotes products and services of the industry, or
- Educates attendees regarding new developments or products and services

Recent Developments – Silo Guidance

Proposed Regulations interpreting Section 512(a)(6), requiring nonprofits to calculate UBTI separately for each trade or business, were published in April.

- Nonprofits can identify separate trades or business using the first two digits of the North American Industry Classification System (NAICS) Codes – 20 different sectors.
- Allocation of general overhead expenses will be covered in future guidance – for now, use any reasonable method
- Exceptions to the silo rules for certain investment activities, as long as they satisfy either a de minimus or control test
- Passive debt-financed income can be treated as investment activity income, as long as it would otherwise qualify for an exception to UBTI
- Charitable Contribution deductions can be taken against total UBTI, after all silo amounts are aggregated

Recent Developments – Net Operating Losses

Grandfathered net operating losses from tax years prior to 2017 can be applied to UBTI for years after 2017 and can offset UBTI by 100%

NOLs from 2017 onward must be applied within their silo, expire after 20 years, and can only be applied to 80% of UBTI

- The CARES Act repealed the 80% UBTI limitation for NOLs arising in 2020, and also provides for a carryback of NOLs.
- There is ambiguity about how these rules interact with the silo rules.

Form 990-T

The Unrelated Business Income Tax Return

- Filing obligations are triggered when there is \$1,000 or more for unrelated business income
- Available for public inspection for section 501(c)(3) organizations

Form 990-T as a Potential Trigger for Audit

The IRS has announced it is taking a data-driven approach to reviewing Form 990 and Form 990-T

- The Form 990 reports UBI but no Form 990-T filed
- Significant UBI from an activity may cause the IRS to investigate
- Substantial UBI may raise excess commerciality concerns

Questions?



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