What is UBIT, and why should I care?

Even though an organization is recognized as tax exempt, it still may be liable for tax on its unrelated business income. For most organizations, unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization’s exemption. An exempt organization that has $1,000 or more of gross income from an unrelated business must file Form 990-T.

For most organizations, an activity is an unrelated business (and subject to unrelated business income tax) if it meets all three of these requirements:

1. It is a trade or business, AND
2. It regularly carried on, AND.
3. It is not substantially related to furthering the exempt purpose of the organization.

Let’s look more closely at each of those three requirements:

"Trade or Business" Defined - The term trade or business generally includes any activity carried on for the production of income from selling goods or performing services. It is not limited to integrated aggregates of assets, activities, and goodwill that comprise businesses for purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which gross income is derived do not lose their identity as trades or businesses merely because they are carried on within a larger framework of other activities that may, or may not, be related to the organization’s exempt purposes.

"Regularly Carried On" - Business activities of an exempt organization ordinarily are considered regularly carried on if they show a frequency and continuity, and are pursued in a manner similar to, comparable commercial activities of nonexempt organizations.

"Substantially related" - To determine if a business activity is substantially related requires examining the relationship between the activities that generate income and the accomplishment of the organization's exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes to be substantially related. (Note: there is no set rule as to what is “substantial”)

There are, however, a number of modifications, exclusions, and exceptions to the general definition of unrelated business income.

Unrelated Business Income Tax Exceptions and Exclusions:
The Internal Revenue Code contains a number of modifications, exclusions, and exceptions to unrelated business income. For example, dividends, interest, certain other investment income, royalties, certain rental income, certain income from research activities, and gains or losses from the disposition of property are excluded when computing unrelated business income. In addition, the following activities are specifically excluded from the definition of unrelated trade or business:

**Volunteer Labor:** Any trade or business is excluded in which substantially all the work is performed for the organization without compensation. Some fundraising activities, such as volunteer operated bake sales, may meet this exception.

**Convenience of Members:** Any trade or business is excluded that is carried on by an organization described in section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees. A typical example of this is a school cafeteria.

**Selling Donated Merchandise:** Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions. Many thrift shop operations of exempt organizations would meet this exception.

**Bingo:** Certain bingo games are not unrelated trade or business.

**Examples:**

**Magazine publishing.** An association of credit unions with tax-exempt status as a business league publishes a consumer-oriented magazine four times a year and makes it available to member credit unions for purchase. By selling a magazine to its members as a promotional device, the organization furnishes its members with a regular commercial service they can use in their own operations. This service does not promote the improvement of business conditions of one or more lines of business, which is the exempt purpose of a business league. Since the activity does not contribute importantly to the organization's exempt function, it is an unrelated trade or business and subject to UBIT.

**Membership list sales.** An exempt educational organization regularly sells membership mailing lists to business firms. This activity does not contribute importantly to the accomplishment of the organization's exempt purpose and therefore is an unrelated trade or business and subject to UBIT.

**Directory of members.** A business league publishes an annual directory that contains a list of all its members, their addresses, and their area of expertise. Each member has the same amount of space in the directory, and its format does not emphasize the relative importance or reputation of any member. The directory contains no commercial advertisement and is sold only to the organization's members. The directory facilitates communication among the members and encourages the exchange of ideas and expertise. Because the directory lists the members in a similar noncommercial format without advertising and is not distributed to the public, its sale does not confer private commercial benefits on the members. The sale of the directory does contribute importantly to the organization's exempt purpose and is not an unrelated trade or business. This directory differs from the publication discussed next because of its noncommercial characteristics.
If however, your organization sells ad space or logo “enhancements” in its directory, see the example on advertising.

**Qualified sponsorship activities.** Soliciting and receiving qualified sponsorship payments is not an unrelated trade or business, and the payments are not subject to unrelated business income tax.

**Qualified sponsorship payment.** This is any payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgment of the business name, logo, or product lines in connection with the organization's activities. “Use or acknowledgment” does not include advertising the sponsor's products or services. The organization's activities include all its activities, whether or not related to its exempt purposes. For example, if, in return for receiving a sponsorship payment, an organization promises to use the sponsor's name or logo in acknowledging the sponsor's support for an educational or fundraising event, the payment is a qualified sponsorship payment and is not subject to the unrelated business income tax.

Providing facilities, services, or other privileges (for example, complimentary tickets, pro-am playing spots in golf tournaments, or receptions for major donors) to a sponsor or the sponsor's designees in connection with a sponsorship payment does not affect whether the payment is a qualified sponsorship payment. Instead, providing these goods or services is treated as a separate transaction in determining whether the organization has unrelated business income from the event. Generally, if the services or facilities are not a substantial benefit or if providing them is a related business activity, the payments will not be subject to the unrelated business income tax.

**Good questions to ask here:**

Does the activity directly or substantially relate to your tax exempt purpose? If no, it is likely subject to UBIT. If yes, go to next question.

Could /would you have done the activity without the sponsor’s support? If not, the revenue is likely not subject to UBIT. If you answer yes, the sponsorship is most likely for the purpose of generating revenue for the non-profit rather than carrying out related activities and subject to UBIT.

One of our larger clients holds an annual convention each year for the purpose of providing educational breakouts, networking opportunities, and conducting association business. These activities are directly related to the client’s non-profit status. The client solicits sponsors for various aspects of the conference such as keynote speakers and networking receptions. In exchange, the association displays the sponsor’s logo at the show. The sponsor receives no other benefit besides acknowledgment, therefore, the sponsorship is not subject to UBIT.

**Advertising.** A payment is not a qualified sponsorship payment if, in return, the organization advertises the sponsor’s products or services. Advertising includes:
1. Messages containing qualitative or comparative language, price information, or other indications of savings or value;

2. Endorsements; and

3. Inducements to purchase, sell, or use the products or services.

The use of promotional logos or slogans that are an established part of the sponsor’s identity is not, by itself, advertising. In addition, mere distribution or display of a sponsor’s product by the organization to the public at a sponsored event, whether for free or for remuneration, is considered use or acknowledgment of the product rather than advertising.

If the payment meets the advertising criteria, it is subject to UBIT. However, advertising revenues from the sale of programs, signage, etc., is generally only taxable to the extent that revenues exceed the direct cost of preparing the publication including staff time.

**Best practice:** Keep track of staff hours, rates paid, design, layout, printing, and postage costs associated with each “activity” such as newsletters, directories, annual reports, and web banner sales. If it is determined that these activities are subject to UBIT, you’ll want to minimize your exposure by documenting the associated costs. But remember, expenses can only be deducted up to the amount of revenues received from advertising.

So why does it matter if your revenue is subject to UBIT? Suppose you generate $100,000 in revenue from various sources listed above. This revenue is not taxed if exempted from UBIT. However, if UBIT applies, these revenues are taxed at ordinary corporate tax rates, as high as 35% or $35,000 in this case. Which is why we recommend you ALWAYS consult a qualified accountant to assist with your tax returns!