

Unrelated Business Taxable Income: What Is Substantially Related?

By Jerrold D. Rosen, JD, CPA

In general, if an organization meets the criteria of Internal Revenue Code 501(c) (e.g., charities, business leagues, social welfare organizations), the revenues that the organization receives are not subject to federal income tax. While this is true for income that is substantially related to the organization's tax-exempt purposes, income that is derived from unrelated trades or businesses conducted may be subject to income tax under the "unrelated business taxable income" (UBTI) provisions of IRC Sections 511-514.

The UBTI was introduced in order to eliminate any unfair competition posed by a tax-exempt organization that is carrying on a business outside its tax-exempt purpose and that is or could be carried on by non-exempt businesses that are subject to income tax. For a tax-exempt organization, the issue is one of fundraising. When grants, contributions, dues or related program fees are not sufficient to allow an organization to carry on its purpose, it may look to selling goods or providing services to its members or the general public to supplement its revenue. This could result in a tax on the net income from the business enterprise.

Defining Conditions

Treasury regulations set forth three conditions that define an unrelated business. They are:

1. The activity must be a trade or business;
2. The trade or business must be regularly carried on; and
3. The trade or business must not be substantially related to the exempt purposes for which the organization was granted tax-exempt status.

All three conditions must be met to establish that the income generated is unrelated business taxable income.

Code Section 512 provides a list of activities that are not considered unrelated business income. Among these is the receipt of dividends, interest, annuity and royalty income, certain capital gains, rental income from non debt-financed real property, income derived from volunteer labor or from the sale of donated goods, and a business carried on by a charity primarily for the convenience of its members, student, patients, officers and employees.

The above list would preclude the treatment of income from bake sales, car washes, or a thrift store (where goods are donated) as unrelated business income. They also cover income received from endowments or investments.

Of course, a tax-exempt organization that opens a bakery that sells goods on a full-time basis generally does not fall under the exemptions.

Examples of Application

The IRS, in PLR 201251019, applied the three-part definition to a specific activity of a 501(c)(3) organization. The organization was formed to educate, promote, encourage or aid children and adults in the appreciation of reading and literacy. The activity was an annual event, taking place on weekends in November and December, at which, the story of a book selected by the organization was recreated on stage with audience participation. The event was promoted and admission charged.

In determining whether the activity is a trade or business, the IRS noted that activities similar to the event were hosted nationwide by both non-profit and for-profit commercial organizations. Because similar events are hosted by the for-profit organizations generally at the same season, the IRS concluded that it was a trade or business.

The IRS then compared the manner of conduct of the event to the manner in which similar commercial activities are conducted and whether the event is conducted with the competitive and promotional efforts typical of commercial endeavors. Finding that the commercial event-type activities are conducted during the same period each year on a seasonal basis and with similar promotional effort as are the exempt organization's event, the IRS concluded that the trade or business is regularly carried on.

With respect to the question of whether the business is substantially related to the organization's exempt purpose, the IRS looked at whether the event contributes to its tax-exempt purpose. The organization provided information that established that the children attending the event are encouraged to be interactive as the book is read to the children. It further established that the children experience the wonder of literature by living the part of the main character. The IRS was able to find that the event furthers the organization's exempt purpose and is substantially related to it.

The IRS then concluded that even though the event is a trade or business regularly carried on in competition with similar commercial activities, the revenue generated did not constitute unrelated business taxable income.

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