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# Unrelated Business Income Tax: An Overview for Associations to Understand, Plan, and Strategize for Revenue Opportunities

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# Nonprofit v. Tax-Exempt Status

- There is a notable difference between a nonprofit organization's "nonprofit" corporate status and its federal "tax-exempt" status; once a "nonprofit" corporation is formed, it does not automatically become federally "tax-exempt"
  - By default, it would be a taxable nonprofit corporation without IRS tax-exemption recognition
- Despite the name, "nonprofits" are not limited in the profits they can earn; it is just that nonprofits have no owners/shareholders and all profits must be reinvested in the corporation in furtherance of its nonprofit mission and purposes
- A nonprofit corporation is organized under the laws of one of the 50 states or DC; most of these laws are largely based on the American Bar Association's Model Nonprofit Corporation Act, the Fourth Edition which is about to be released

## Nonprofit v. Tax-Exempt Status – *cont.*

- State nonprofit corporation statutes regulate a wide array of governance, operations and activities of nonprofit corporations, including things that the nonprofit must do and things that it can't do
- State nonprofit corporation statutes also contain “default” provisions in the event that certain matters are not addressed by/in the nonprofit's Articles of Incorporation or Bylaws
- A nonprofit corporation's internal governance rules (*e.g.*, Bylaws, policies) must be consistent with the nonprofit corporation statute of the state of incorporation; the hierarchy is as follows (everything must be consistent with what is above it):
  - State nonprofit corporate statute
  - Articles of Incorporation
  - Bylaws
  - Board- and staff-adopted policies

# Federal Tax-Exempt Status – Overview

- The vast majority of all nonprofit corporations are recognized as exempt from federal corporate income tax under Section 501(c)(3) of the Internal Revenue Code; this tax-exempt status provides numerous benefits but also imposes material limitations and prohibitions
- Other nonprofit corporations are recognized as exempt from federal corporate income tax under other sections of the Internal Revenue Code (e.g., Sections 501(c)(6) (trade and professional associations and chambers of commerce), 501(c)(4) (social welfare organizations), 501(c)(5) (labor unions and agricultural organizations), and 501(c)(7) (social clubs))
- Federal tax-exempt status is generally recognized through the filing of an application with the IRS for recognition of such tax-exempt status (e.g., IRS Form 1023 or 1024)

## Federal Tax-Exempt Status – Overview – *cont.*

- Most tax-exempt entities are required to file some form of the IRS Form 990 each year – either the Form 990, Form 990-EZ, or Form 990-N, depending on the size of the organization, or Form 990-PF for private foundations – and are required to file the IRS Form 990-T (and make quarterly estimated tax payments) if unrelated business income (UBI) is earned; all such forms are subject to public disclosure, except the Form 990-T is only subject to public disclosure for 501(c)(3) organizations
- Tax-exempt entities can earn (and pay federal and state corporate income tax on) UBI but cannot earn more than an “insubstantial” amount of UBI in the aggregate
- Recognition of federal tax-exempt status can generally be utilized to confer virtually automatic exemption from state corporate income tax (in the state in which the organization’s principal office is located (not the state of incorporation)); most states require that the tax-exempt entity file a copy of its Form 990 with the state each year

# Origins and 1950 Congressional Enactment of UBIT Statute

- *C.F. Mueller Company* (1951 Third Circuit Decision) – New York University Law School purchased the C.F. Mueller Company pasta manufacturing company, with all profits from the company dedicated to the Law School and its tax-exempt purposes
- The Third Circuit Court of Appeals reversed the U.S. Tax Court’s decision that had held that the Law School was no longer organized and operated exclusively for charitable purposes, relying on the then-“use-of-funds” test, thereby upholding the Law School’s position and its tax-exempt status
- In 1950, concerned about unfair competition against taxable entities, Congress enacted the UBIT statute, eliminating the use-of-funds test and imposing today’s current UBIT regime, effective 1/1/51; with a few exceptions, the statute has been largely unchanged since then

# IRS Definition of Unrelated Trade or Business

The term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 511, 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 charitable, educational, or other purpose or function constituting the basis for its exemption under section 501...**

– Internal Revenue Code Section 513

# What Is Unrelated Business Income?

- What is unrelated business income (UBI)? Income from:
  - (1) A trade or business;
  - (2) That is regularly carried on; *and*
  - (3) That is not substantially related to furthering the organization's tax-exempt purposes
- *All* three prongs must be satisfied for UBI to exist; it is a “facts-and-circumstances” test



## What Is Unrelated Business Income? (cont.)

- More than “insubstantial” total UBI can jeopardize an organization’s tax-exempt status, but alternatives such as taxable subsidiaries are available
- Even if the three prongs of the UBIT test are satisfied, there are numerous specific *exceptions* and *exclusions* from UBI that may apply

# Is the Income that is Usually Taxable as UBI

- Income that Is Usually Treated as Unrelated Business Income (UBI):
  - Advertising income (includes ads in periodicals and moving banner advertisements on websites)(nonprofits' programs can be segregated into related and unrelated components for taxation purposes, with periodical subscription sales usually being related and advertising in periodicals almost always being unrelated)(special IRS regulations apply to calculating membership associations' UBIT from periodical advertising)(theoretical advertising exception from UBIT if all ads are strictly tied to all editorial content: *U.S. v. American College of Physicians* (U.S. Supreme Court, 1986))
  - Rental income received from debt-financed property
  - Payments from certain “controlled” entities (*e.g.*, rents or royalties from majority-owned or -controlled subsidiaries)

# UBIT – Miscellaneous

- There is a \$1,000 corporate income tax deduction for UBIT
- UBI is taxed at the flat corporate income tax rate of 21%
- There is a tax deduction against UBI for directly connected expenses incurred to generate the UBI
- Net operating losses (NOLs) are generally permitted unless recurring for a number of years, which suggests no profit motive (and thus no tax deductibility)
- Tax-exempt organizations can no longer offset losses from one unrelated business activity against gains from another unrelated business activity (profits and losses are determined *per* activity)
- Quarterly estimated tax payments must be made at the federal and state levels for UBIT
- IRS Form 990-T subject to public disclosure for 501(c)(3) organizations only

# Exclusions from UBI

- Income that is *specifically excluded* from UBI:
  - Qualified corporate sponsorship income
  - Royalty income
  - Qualified convention and trade show income (open question presently about how/whether *virtual-only* trade shows qualify)
  - Interest, dividends, annuities, and certain capital gains
  - Certain non-debt-financed rental income from real property
  - Volunteer labor (85% or more conducted by unpaid volunteers)
  - Sale of donated goods
  - Certain research income
  - Certain bingo games
  - Renting mailing list to another charitable organization

# **UBIT Exceptions: Qualified Corporate Sponsorship Income**

# Qualified Corporate Sponsorship Payments – Overview

- Qualified Corporate Sponsorship Payments
  - Safe Harbor: There is no arrangement or expectation that the payor will receive a substantial return benefit (valued at 2% or less of the sponsorship payment)
    - Other than the use or acknowledgment of the name or logo (or product lines) of the payor's trade or business in connection with the nonprofit's activities
    - Applicable to a broad range of temporary and permanent activities (including websites), *excluding*:
      - Trade show and convention activities (covered by another UBI exception)
      - Advertisements or acknowledgment in periodicals (*e.g.*, magazines, newsletters)(but mere acknowledgements in periodicals may not trigger UBI)
      - Contingent payments

# Illustration

- JST Corporation makes \$5,000 gift to the Philanthropy Foundation (2% = \$100)
  - Example #1 – \$60 return benefit – Safe harbor
    - \$20 educational event tickets
    - \$30 advertising in event program
    - \$10 board dinner
  - Example #2 – \$150 return benefit – No safe harbor (but not necessarily UBI)
    - \$50 licensing rights (not taxed, passive royalty)
    - \$50 educational event tickets (not taxed, “related” income)
    - \$50 advertising in event program (taxed at market rates)

**NOTE:** The tax treatment of a donation or payment from a sponsor to a tax-exempt organization has no bearing on the tax deductibility of the donation or payment to the sponsor as a charitable donation or business expense; that analysis is separate and distinct, and is affected by issues such as donative intent, the value of benefits received in return, the tax status of the tax-exempt organization, and the connection to the payor’s business

# Analyzing Benefits

1. Acknowledgment or Advertising?
2. Eligible for the Safe Harbor?
3. Determine the Value of “Eligible” Benefits
4. Conduct the Standard Three-Prong UBIT Analysis on Whatever Is Not Covered by the Safe Harbor (Not Qualifying for the Corporate Sponsorship Safe Harbor Does Not Necessarily = UBI)



# 1. Acknowledgement or Advertising?

- **Acknowledgment**

- Name or logo
- Description of services or product lines, as long as use is not *qualitative* or *comparative*:
  - But slogans which are an established part of identity are permissible
- Contact information, including list of sponsor's address, telephone number, email address, and/or web address, including a hyperlink from the nonprofit's website to the sponsor's website (main landing page – not to product or service purchase page) (moving banner likely inconsistent with acknowledgment)
- Product displays, visual depictions, product samples (whether products are sold or are given out for free)

- **Advertisement**

- Qualitative or comparative language, price information, indications of savings or value, endorsements, inducement to purchase, sell or use

## 2. Eligible for Safe Harbor?

Safe harbor does not apply to (apply standard UBIT analysis):

- Over 2% – Sponsorship payments where return benefit is over 2%; in such cases, only the portion (if any) of the payment that exceeds the FMV of the return benefit (at the time the arrangement is entered into or renewed) will be considered a qualified sponsorship payment
- Contingent Payments – Where the level of payment depends on attendance numbers, broadcast ratings, web hits, social media likes, etc. (but not if contingent on the event occurring at all)
- Exclusive *Provider* Arrangements – *e.g.*, right to be the exclusive provider of soft drinks at an event (Reg. §1.513-4(f), Ex 6) – but exclusive *sponsor* arrangements are consistent with the safe harbor

# Eligible for Safe Harbor? – *cont.*

- Convention or Trade Show
  - Exhibit booths, tickets to trade show, acknowledgement at trade show, etc.
    - But generally covered by the convention and trade show UBI exception
- Advertising or Acknowledgement in Periodicals
  - The safe harbor does not apply to periodicals (print or electronic)
  - Illustration: A textbook publisher makes a large payment to have its name displayed on the inside cover of the nonprofit's monthly magazine (Reg. §1.513-4(f), Ex. 10)
    - Because the magazine is a periodical, the safe harbor does *not* apply
    - Mere *acknowledgement* in an event program guide is likely covered by the safe harbor, but *advertising* in an event program guide is not (Reg. §1.513-4(f), Ex. 8)
- Mere Acknowledgements in Periodicals (Thanking/Acknowledging Sponsors/Donors) Likely Still Tax-Exempt Even Though Not Covered by the Safe Harbor
  - Due to not satisfying the three-prong UBIT analysis

# 3. Determine Value of Eligible Benefits

- **Valuation Period**

- Valuation is applied to each tax year of a multi-year agreement – impacts pay up-front agreements

- **Valuation Date**

- If a contract specifies the (good faith and reasonable) “market value,” then the valuation date is the date of the contract:
  - Resets if there is a material change, including renewal or extension
- If no contract, then the date that a benefit is provided

# Essentials for Corporate Sponsorship Contracts

- Specify exact form of acknowledgment
- Specify all return benefits
- Specify value of taxable benefits
- Break out the various components separately
- Have right to approve any copy relating to sponsorship, or any use of tax-exempt's name/logo (and include a specific, limited license of the tax-exempt's name/logo)
- Specify the specific site to which hyperlinks will link

# UBIT Exceptions: Royalty Income

# Specific Exclusions – Royalties

- Passive royalty income is excluded from UBIT
- What is a royalty?
  - *Sierra Club v. Commissioner*: “Payments received for the right to use intangible property rights and that such definition does not include payments for services”
- Components:
  - Name, trademark/service mark, and membership/ mailing list
  - Third-party product
    - *e.g.*, affinity card, endorsed product or service
    - Outsourcing of magazines/journals often not eligible for royalty treatment
  - No active promotion (or quantify value and pay tax)
    - Announcement email/letter is OK
    - Quality control measures are OK and highly recommended

# Royalties – License of Name and/or Logo

- General rule: The less an organization does, the more likely income is to be characterized as royalty income
- Evidence of royalty relationship
  - Payment relates to use of a valuable right
  - An organization's activities are generally limited to those necessary to protect its reputation:
    - Review use of name and logo for quality and style
    - Limit the use of name and logo to approved circumstances
- Evidence of other (usually service) relationship
  - Marketing services (promoting the product/service) and/or administrative services (helping to administer the program)
  - Significant activities or rights, such as approval of editorial content and preparing articles in a periodical
  - Existence of a *quid pro quo* transaction



# Royalties – License of Name and/or Logo – *cont.*

- The IRS has taken a strict position with royalty income, but lost most of the litigation that transpired over 30 years ago, and the IRS' position has softened a bit over the years
- Dual-purpose relationships:
  - If the service component is minimal, this is likely not an issue and can all be treated as tax-free royalties
  - If the service component is significant:
    - The IRS will likely determine that none of the income is royalty income
    - Courts have looked to the entire relationship to determine what the nonprofit is actually getting paid for on a fair market basis (*e.g.*, what is the value of the exclusive name/logo license (endorsement) versus the value of the services being provided?)

# Royalties – License of Name and/or Logo – *cont.*

- Dual-purpose relationships best practices:
  - The IRS would prefer two separate agreements; this is usually not necessary
  - Clearly identify and bifurcate the royalty and service components and payments in the agreement based on a fair market value allocation
  - Be reasonable
  - Do not title the agreement, “Service” or “Marketing” Agreement

# Royalties – Example – Affinity Credit Cards

- Courts have ruled that payments received by organizations through affinity credit card relationships are for valuable intangible property – the organization’s name, logo and mailing lists
- The issue is whether an organization is receiving a payment for the use of and the goodwill associated with the organization’s name and logos, or a payment for promotional and mailing list management services – or both; if both, there needs to be a reasonable, fair market allocation between the two
- Courts have held that the *amount* of services provided *does* matter

# Questions?

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