UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

33rd Annual Nonprofit Organizations Institute

January 14-15, 2016
Austin, Texas

Then You Need to Keep It: Complex UBIT Issues and Strategies for Coping

Terri Lynn Helge
Texas A&M University School of Law
Fort Worth, TX

Author Contact Information:
Terri Lynn Helge
Professor of Law
Texas A&M University School of Law
1515 Commerce Street
Fort Worth, TX 76102
Email: thelge@law.tamu.edu
Phone: 817-212-3942

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I. Introduction. This paper summarizes the unrelated business income tax rules as they apply to tax-exempt charitable organizations described in Section 501(c)(3) of the Code.[1] Since the 1950s, the unrelated business income tax has been imposed on a charity's net income from a regularly carried on trade or business that is unrelated to the charity's tax-exempt purposes. Often times, the justification for imposing this tax on a charity's net income from unrelated business activities is that such activities involve unfair competition with the charity's for-profit counterparts.[2]

II. Unrelated Business Income Tax ("UBIT"): General Rules.[3]

A. Definition of Unrelated Business. Organizations described in Section 501(c)(3) of the Code are generally subject to income tax on the net income produced from engaging in an unrelated trade or business activity.[4] The term "unrelated trade or business" means an activity conducted by a tax-exempt organization which is regularly carried on[5] for the production of income from the sale of goods or performance of services[6] and which is not substantially related to the performance of the organization's charitable, educational or other exempt functions.[7]

1. Activity is a "Trade or Business." For purposes of the unrelated business income tax regime, "the term 'trade or business' has the same meaning it has in Section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services."[8] Section 162 of the Code governs the deductibility of trade or business expenses. In that context, the U.S. Supreme Court has declared that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer's primary purpose for engaging in the activity must be for income or profit."[9] When applying this test, the IRS may take into account a key purpose of the unrelated business income tax: to prevent unfair competition between taxable and tax-exempt entities. "[W]here an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations."[10] However, the mere fact that the activity

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[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended.

[2] *See* Treas. Reg. § 1.513-1(b) ("The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.").

[3] Portions of this discussion on unrelated business income are extracted from the author's previously published article, *The Taxation of Cause-Related Marketing*, 85 CHI-KENT L. REV. 883 (2010).

[4] *See* I.R.C. § 511.

[5] Treas. Reg. § 1.513-1(a).

[6] I.R.C. § 513(c); Treas. Reg. § 1.513-1(b).

[7] I.R.C. § 513(a).

[8] Treas. Reg. § 1.513-1(b).

[9] Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

[10] Treas. Reg. § 1.513-1(b). *But see* La. Credit Union League v. United States, 693 F.2d 525, 542 (5th Cir. 1982) ("[T]he presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to be taxed.").

is conducted as a fund-raising activity of the charity is not sufficient to conclude that the activity is not a trade or business.[11]

The most important element as to whether the activity is a trade or business is the presence of a profit motive. In the context of a tax-exempt organization, the U.S. Supreme Court declared that the inquiry should be whether the activity "'was entered into with the dominant hope and intent of realizing a profit.'"[12] Significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.[13] When the activity involved is highly profitable and involves little risk, courts generally infer the presence of a profit motive.[14] An activity that produces consistent losses may indicate that no profit motive exists, and therefore the activity is not a trade or business. This determination may prevent an exempt organization from offsetting UBTI from profitable activities with losses from a consistently unprofitable activity.

2. Regularly Carried On Requirement. In general, in determining whether a trade or business is "regularly carried on," one must consider the frequency and continuity with which the activities productive of income are conducted, and the manner in which they are pursued. Business activities are deemed to be "'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[15] For example, "[w]here income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business *[sic]*."[16] Similarly, "income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically."[17] However, "[w]here income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business."[18]

In making this determination, it is essential to identify the appropriate nonexempt commercial counterpart to the exempt organization's activity, because the manner in which the nonexempt commercial counterpart conducts its similar activities has an important bearing on whether the activity is considered to be carried on year-round, on a seasonal basis or intermittently. For example, a tax-exempt organization's annual Christmas card sales program was determined to be regularly carried on when

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[11] *See Am. Bar Endowment*, 477 U.S. at 115 (stating that a charity cannot escape taxation by characterizing an activity as fundraising, because otherwise "any exempt organization could engage in a tax-free business by 'giving away' its product in return for a 'contribution' equal to the market value of the product").

[12] United States v. Am. Bar Endowment, 477 U.S. 105, 110, n. 1 (1986) (quoting Brannen v. Comm'r, 722 F.2d 695, 704 (11th Cir. 1984).

[13] Ill. Ass'n of Prof'l Ins. Agents v. Comm'r, 801 F.2d 987, 992 (7th Cir. 1986).

[14] *See, e.g.*, Carolinas Farm & Power Equip. Dealers Ass'n, Inc. v. United States, 699 F.2d 167, 170 (4th Cir. 1983) ("[T]here is no better objective measure of an organization's motive for conducting an activity than the ends it achieves."); La. Credit Union League v. United States, 693 F.2d 525, 533 (5th Cir. 1982) (finding that a profit motive existed based on the fact that the organization was extensively involved in endorsing and administering an insurance program that proved highly profitable); Fraternal Order of Police Ill. State Troopers Lodge No. 41 v. Comm'r, 87 T.C. 747, 756 (1986), *aff'd*, 833 F.2d 717 (7th Cir. 1987) (reasoning that the organization's advertising activities were "obviously conducted with a profit motive" because the activities were highly lucrative and with no risk or expense to the organization).

[15] Treas. Reg. § 1.513-1(c)(1).

[16] Treas. Reg. § 1.513-1(c)(2)(i).

[17] Treas. Reg. § 1.513-1(c)(2)(iii).

[18] Treas. Reg. § 1.513-1(c)(2)(i).

Title search: Then You Need to Keep It: Complex UBIT Issues and Strategies for Coping

First appeared as part of the conference materials for the
33rd Annual Nonprofit Organizations Institute session
"Then You Need to Keep It: Complex UBIT Issues and Strategies for Coping"