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Selling for Good: Merchandising & Corporate Sponsorship Ideas that Don't Create UBIT

Nicola Fuentes Toubia

Kyle ZumBerge

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Nicola Fuentes Toubia
Fuentes Toubia, PLLC
2450 Louisiana, Suite 400
Box 936
Houston, Texas 77006
nicola@toubialaw.com

Kyle ZumBerge
Office of General Counsel
The University of Texas System
201 W. 7th Street, Suite 600
Austin, Texas 78701
kzumberge@utsystem.edu

I. Introduction

A. To maintain tax-exempt status under section 501(c)(3), an organization must be organized and operated exclusively for tax-exempt purposes.[1] However, an insubstantial amount of an organization's activities may be spent on nonexempt purposes.[2] Charitable organizations engage in a variety of commercial activities that may support an exempt purpose or may solely serve as a way to raise revenues for the organization.

B. Unrelated Business Income Tax[3] (UBIT) Summary

1. Section 511(a)(1) imposes a tax on the unrelated business taxable income (UBTI) of charitable organizations equal to the corporate tax rate under section 11.

2. Policy: to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the

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1 Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C.") and the regulations promulgated thereunder.

2 Treas. Reg. §1.501(c)(3)-1(c)(1).

3 This topic primarily addresses the UBTI rules as they effect section 501(c)(3) organizations. However, all organizations described in section 401(a) and 501(c) (other than instrumentalities of the United States described in section 501(c)(1)) are subject to a tax on their UBTI. I.R.C. §511(a)(2).

same tax basis as the nonexempt business endeavors with which they compete.[4]

3. Section 513(a) defines an unrelated trade or business as "any trade or business the conduct of which is *not substantially related* … to the exercise or performance" by a tax-exempt organization of "its charitable, educational or other purpose or function constituting the basis for its exemption under section 501 …".[5]

II. UBIT Element One: Income from a Trade or Business

A. The term "trade or business" has the same meaning as it has in section 162. It includes any activity carried on for the production of income from the sale of goods or the performance of services.[6] The IRS takes a broad view of "trade or business."[7]

B. Fragmentation Rule:

1. Provides that business activity of an exempt organization may be treated as an unrelated trade or business even though the activity is carried on within the broader scope of similar activities that may be related to the organization's exempt purpose.[8]

2. "Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as a 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 purpose of the organization."[9] For example, pharmaceutical sales by a hospital to non-patients do not fail to constitute a trade or business merely because the hospital also sells drugs to its patients in accordance with its exempt purpose.[10]

3. Technical Advice Memorandum 201633032 (Sept. 18, 2016).

(a) Although much of the facts in this technical advice memorandum are redacted, the tax press believes it involves a charitable organization whose exempt purpose was to preserve heritage seed stock from disappearing. As part of this purpose, the organization sold seed packets online, in catalogs, and at its visitor center.

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4 *See* The Revenue Act of 1950, c. 994, 64 Stat. 906, which added the UBIT rules to the Internal Revenue Code of 1939.

5 I.R.C. §513(a) (emphasis added).

6 Treas. Reg. §1.513-1(b).

7 *See Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (finding a trade or business activity where the activity is entered into with the dominant hope of making a profit);

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

9 Treas. Reg. §1.513-1(b).

10 *Id.*

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