Tax Implications for Nonprofit Business Activities
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Nonprofits May Have to Pay Taxes on Certain Activities
BY JOANNE FRITZ Updated on May 28, 2020

Although 501(c) organizations are generally exempt from federal and state taxes, some income may be subject to a special tax called the UBIT (unrelated business income tax). (1)

Any income from "related" business activities, or those that help sustain a nonprofit's primary mission, is tax-exempt. Unrelated business activity, however, may be subject to UBIT. (1)

The Difference Between Related and Unrelated Business Activity
Determining the difference between mission-related income and unrelated income can become quite complicated. (2)

For example, a museum offers summer courses to high school students in art appreciation for a fee. Since the museum's mission involves educating the public about art, the proceeds from such classes are likely tax-exempt.

On the other hand, let's say the museum publishes a magazine that carries advertising that has nothing to do with its mission of art education and preservation. The income from that advertising may be considered unrelated, and therefore taxable. (3)

The IRS says that unrelated business activity has these three attributes:

- It is a trade or business,
- It is regularly carried on, and
- It is not substantially related to furthering the exempt purpose of the organization. (4)

So, a nonprofit pre-school's once-in-a-while bake sale would not qualify for UBIT, but running a pizza parlor on the side likely would.

How Much Unrelated Business Income Does the IRS Allow?
The Internal Revenue Service has not been specific about how much permissible earned income can be generated by unrelated sources.5

Although no fixed percentage limitation exists for unrelated business income, there are two main reasons why unrelated business income raises concern for public charities and most other exempt organizations under Internal Revenue Code section 501(c).

First, unrelated business income is taxable at the corporate tax rate (i.e., subject to UBIT).6
Second, an exempt organization cannot engage in more than an insubstantial amount of unrelated business activity without risk of losing its tax-exempt status.7

An "unrelated business" is defined by the IRS as a trade or business that is regularly carried on, and not for the most part related to the exempt purpose of the organization.4

A related business means that the income-generating activity supports the organization's exempt purposes and does not just produce income.8

Whether or not the activity produces income is not the most crucial fact. <u>But what does matter is if that activity supports the organization's mission or purpose.</u>

The analysis of related vs. unrelated business activities can become quite complex. For instance, individual items sold in a museum gift shop could be classified either way, depending on any number of factors.9

For instance, there are exceptions to the rule under Internal Revenue Code section 513(a) for certain activities.10 They include:

Activities run by a volunteer workforce.
Activities carried on for the convenience of its members, students, patients, officers, or employees.
Selling of donated merchandise.
Passive income, such as interest, dividends, rents, and royalties, are generally excluded from unrelated business income.
Serious issues would likely exist under the unrelated business income rules for an organization with more than 50% of its total gross income produced from unrelated business activity. However, regulations are imprecise about where to draw the line below that 50% mark.

Without a fixed percentage limitation from the IRS, legal advisers often use various rules of thumb, although 20% is common.11

What to Watch for
Too much unrelated commercial activity may prompt the IRS to take a second look at your 501(c)(3) tax-exempt status.7 There are some steps you can take to help prevent this.

Make sure that your business activity doesn't absorb too many resources from staff or volunteers.
Always keep in mind what your mission is. Focus most of your resources on that.
Don't let the income from unrelated business ventures become too large a percentage of your total annual income. Public charities are required to get at least one-third of their revenue from the public, such as from donations or fees from mission-related programs.12
File the appropriate tax forms if you have $1,000 or more of gross income from the unrelated business activity.4 You must file Form 990-T when you file your 990, 990-EZ, or 990-PF.

Organizations should seek appropriate counsel or expertise when engaging in business activities. If the activities do not meet the definition of an unrelated business or fall under an exception or exclusion, the organization may have much more flexibility in how it engages in such activities without triggering any penalties.

It's essential to consult your legal counsel and your tax expert before you jump into anything that might trigger the UBIT. The IRS provides details on unrelated business income tax on its website.

The information contained in this article is not tax or legal advice and is not a substitute for such advice. State and federal laws change frequently, and the information in this article may not reflect your own state's laws or the most recent changes to the law. For current tax or legal advice, please consult with an accountant or an attorney.

ARTICLE SOURCES

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