

# THE APPLICATION OF UNRELATED BUSINESS INCOME TAX (“UBIT”) TO EXEMPT ORGANIZATIONS

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A common misconception is that all charities, non-profit organizations, and government entities are exempt from Federal income taxation. However, the Code imposes a tax on unrelated business taxable income on organizations described in §401(a) and §501(c).<sup>2</sup> Additionally, some government entities (state colleges and universities) are subject to the unrelated business income tax.<sup>3</sup>

Most non-profit organizations are exempt from tax because there is a provision in the Code for the exemption. Treatment as a tax exempt organization is automatic for churches or organizations that generate less than \$5,000 in gross receipts per year. Otherwise, an application must be filed and approved with the IRS to obtain exempt status.<sup>4</sup>

The primary objective of the unrelated business rules is to eliminate a source of unfair competition with for-profit businesses.<sup>5</sup> An organization may not qualify for exemption if a substantial portion of income is from unrelated business activities and the IRS may revoke tax exempt status.<sup>6</sup> A related concept to unrelated business is the test that an exempt organization must avoid private inurement and instead benefit civil society.<sup>7</sup>

Income must be generated from a trade or business to be subject to UBIT. The Code describes a trade or business as any activity which is carried on for the production from the sale of goods or the performance of services.<sup>8</sup> Revenue generated by an exempt organization in connection with an activity that is substantially related to the purpose of the organization is not business income subject to UBIT. For example, if a university generates revenue from advertisements placed in a student newspaper, the activity contributes substantially to the educational mission of the university and the revenue is not unrelated business income.<sup>9</sup>

Income earned from business activities that are not regularly carried on is related business income. Activities of an exempt organization are regularly carried on if they occur frequently and are carried out in ways that are similar to commercial activities of

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<sup>2</sup> IRC §511(a)

<sup>3</sup> Ibid

<sup>4</sup> IRS Form 1023 Instructions

<sup>5</sup> IRC Reg. §1.513-1(b)

<sup>6</sup> Bruce R. Hopkins, *The Tax Law of Unrelated Business for Nonprofit Organizations* 12 (John Wiley & Sons, Inc.) (2005).

<sup>7</sup> Ibid at 16

<sup>8</sup> IRC §513(c)

<sup>9</sup> IRC Reg. §1.513-1 Example 5

nonexempt organizations.<sup>10</sup> For example, the operation of a sandwich stand by an exempt organization at a state fair for two weeks is likely unrelated to its exempt purpose, but would probably not be considered a regular trade or business. However, the operation of a commercial parking lot every Saturday of each week would be considered a regularly carried on activity.<sup>11</sup>

This article is intended to be a brief introduction to this highly specialized niche, and the preceding criteria represent some of the more important hallmarks of UBIT. There are many exceptions and other facts that should be evaluated in the determination if a particular activity is unrelated and if income generated is subject to UBIT. As with any area in tax law, practitioners should be well informed and current with regulations and legal opinions in place before delivering quality advice to clients.

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<sup>10</sup> IRC Reg. §1.513-1(c)(1)

<sup>11</sup> IRC Reg. §1.513-1(c)(2)(i)