Unrelated Business Income
KLR Not-for-Profit Services Group
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Unrelated Business Income- understanding some key concepts in a complex subject

**In general** the term “unrelated business taxable income” means the gross income derived by an organization from any unrelated trade or business, regularly carried on by it, less the deductions normally allowed in that business.

The phrase “unrelated trade or business” means, in the case of a not-for-profit organization, 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 or performance of any purpose or function described in section 501(c)(3).

There are some specific UBI exceptions for specific activities contained in Internal Revenue Code Sections 511 and 512. Unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

**The significance of the phrase *Trade or business*:**

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. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of Internal Revenue Code 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.

Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived does not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of IRC section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising does not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. Where an activity, carried on for the production of income, constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.
The significance of the term \textit{regularly carried on} \\

(1) General principles. In determining whether trade or business is “regularly carried on,” within the meaning of the unrelated business income section of the Internal Revenue Code, one must look at the frequency and continuity with which the activities are conducted and the manner in which they are pursued. In addition, this requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be “regularly carried on” if they manifest a frequency and continuity, and are pursued in a manner that is generally similar to comparable commercial activities of nonexempt organizations.

(2) Application of principles in certain cases.

(i) Normal time span of activities. Where 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 \textit{regularly carrying on} of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where 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. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

(ii) Intermittent activities; in general. In determining whether or not intermittently conducted activities are \textit{regularly carried on}, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered \textit{regularly carried on} if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the \textit{regularly carried on}. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or “primarily for the convenience” of such persons (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the non-qualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the requirement of regularity.
(iii) **Intermittent activities**; a special rule exists in certain cases of infrequent conduct. Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, 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. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund-raising event for charity would not be income from trade or business regularly carried on.

**Is and activity unrelated or substantially related?**

(1) *In general.* Gross income is derived from an “unrelated trade or business,” if the conduct of the trade or business which produces the income is not *substantially related* (other than through the production of funds) to the purposes for which organization is tax-exempt. The presence of this requirement requires an examination of the relationship between the business activities in question and the accomplishment of the organization’s exempt purposes.

(2) *Type of relationship required.* A trade or business is “related” to an organization’s exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of the organization’s exempt purposes (other than through the production of income). It is “substantially related” only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be *substantially related* to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute *importantly* to the accomplishment of the organization’s exempt purposes. Where the production of the income does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income does not derive from the conduct of a *related* trade or business. Whether activities that produce gross income contribute *importantly* to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

(3) *Size and extent of activities.* In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business.
Exceptions

The Internal Revenue Code specifically states that the term “unrelated trade or business” does not include:

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization by volunteers without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees; or,

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.
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