Are Your Activities Safe from UBIT?

Might the IRS decide to tax your organization's activities? Use this UBIT clarification to head off any IRS challenges.

BY JOHN R. LEAVINS & DARSHAN WADHWA

Nonprofit organizations often earn revenue from activities unrelated to their tax-exempt purpose. But which activities are related and which are unrelated? There's often a fine line between the two, and the IRS's rulings on the matter are sometimes confusing. That makes sense when you realize that the concepts of unrelated business income (UBI) and the unrelated business income tax (UBIT) are relatively new. To gain perspective on this important topic, let's look at a bit of background.

Historical Development

The original income tax act, which first imposed income taxes in 1913, specifically exempted nonprofit organizations from tax. This policy reflected the view that charitable organizations benefit the public and should therefore be tax-exempt.

Since then, many have questioned the fairness of exempting income not related to the purpose for which the exempt entity was formed. One of the first such challenges was *Trinidad v. Sagrada Orden de Predicadores* in 1924. A nonprofit organization in Trinidad was formed and qualified as an exempt organization under Section 501(c)(2)(B). The organization raised funds from real estate and investment holdings, as well as the sale of wine, chocolate, and other articles. The IRS argued that the organization wasn't operated exclusively for exempt purposes since some of its funds were raised from commercial businesses. The IRS took the position that the income earned from commercial enterprises should be taxed.

> UBIT is a relatively new concept.

In the IRS's view, it was irrelevant that the income was used exclusively for exempt purposes. The Supreme Court disagreed and held that the income was exempt based on how it was used rather than how it was earned. The Supreme Court thus established the "destination-of-funds" doctrine: As long as funds were *used* for an exempt purpose, it was irrelevant how the funds were acquired.

For the next 25 years, many abuses of the "destination of funds" doctrine occurred, since many nonprofits now viewed it as acceptable to expand their activities into areas totally unrelated to their tax-exempt purpose. Business owners complained that they were facing "unfair competition" from exempt organizations. Such protests resulted in the Revenue Act of 1950, which introduced unrelated business income (UBI) and the unrelated business income tax (UBIT). Congress rejected the notion of the "destination-of-funds" principle in favor of a focus on the income's *source*. Thus, any income that an organization received from conducting unrelated activities was taxable, whether or not the income was used to further its charitable purposes.

Current Law

Under current law, an exempt organization is generally subject to tax on income earned from any trade or business not substantially related to its tax-exempt purpose. This includes income from selling merchandise or performing services. To be related to the accomplishment of the exempt purpose, the conduct of the business activity must contribute importantly to that exempt purpose. For the tax to apply, the activity must also be "regularly carried on." Factors to consider in applying the regularly-carried-on test include the frequency and continuity of the activity.

Congress and the IRS have exempted certain activities from UBIT. The rationale for doing so is that these aren't profit-making activities which unfairly compete with taxable businesses. These exempted activities include the following:

- activities in which individuals perform substantially all the work without compensation
- the selling of merchandise which has been received as gifts or contributions
- activities conducted primarily for the convenience of the organization's members, students, patients, officers, or employees
- "passive" income such as dividends, interest, royalties, most income from rental property, and gains from sales of property.

Factors to consider include the frequency and continuity of your activities.

Application of the Current Law

Opinions differ over what constitutes an unrelated trade or business. This disagreement in interpretation has produced many court cases.

The case of *American Academy of Family Physicians v. U.S.*, decided in August, 1996, is an example. The American Academy of Family Physicians, a tax-exempt association, owns and sponsors group insurance plans that are available for its members. The Academy engaged a private insurance carrier to collect premiums from the association's members and then issue and underwrite the policies. The insurance carrier set aside the premiums for payment of future claims. The agreement required that when the policies were terminated and all claims paid, any remaining reserves would be paid to the Academy. In addition, the insurance carrier was required to make annual payments to the Academy for the use of the insurance funds. These payments, based on a fixed percentage of the reserves, had to be made whether or not the plans were profitable.

The IRS contended that these annual payments were compensation for the Academy's sponsorship of the insurance plans and weren't substantially related to the organization's purpose. Thus, the IRS ruled the income taxable as unrelated business income. It assessed the Academy $600,000 in back taxes.

The Academy countered that its participation in the insurance plan didn't constitute a "trade or business" under section 513. Furthermore, payments from the carrier were interest, which is specifically excluded from UBIT.

In deciding the case, the court dealt with two questions:

1. Was the activity entered into with a profit motive, and was the Academy's role in the insurance program extensive or significant? If there was no profit motive and the activity wasn't extensive or significant, then the income from the activity wouldn't be considered UBI.

2. Could the annual payments be classified as interest? If so, then the income wouldn't be taxable regardless of the profit motive and extensive nature of the activity.

In its decision, the court cited previous rulings that "the exempt organization must carry out extensive business activities over a substantial period of time to be engaged in a trade or business." The court held that the Academy didn't have the profit motive required for a trade or business since it entered the activity for its members' benefit.

In addition, the court held that the Academy's involvement in the insurance plans was not "extensive" and therefore didn't possess the characteristics of a trade or business. The court pointed out that the insurance carrier processed the applications for insurance and made decisions about coverage. The Academy didn't have administrative or underwriting responsibilities.

The court also stated that the Academy didn't use its tax-exempt status to seek a competitive edge for the insurance program. In the court's view, the Academy didn't act like an insurance company in the traditional sense, and its involvement in the insurance program was not significant enough to constitute a trade or business.

Since the court decided that the activity wasn't a trade or business, UBIT didn't apply, and the issue of whether the payments represented interest wasn't relevant to the outcome. The court spoke to the issue, however, pointing out that payments were based on a specified, annual percentage of insurance reserves and were due regardless of profitability. The court thus held for the Academy in both instances. None of the income generated through the insurance program was taxable.

If there is no profit motive, then the income from the activity isn't UBIT.

As this case illustrates, it's crucial that nonprofits carefully evaluate potential commercial activities in terms of possible UBIT application. Proper planning and consultation with professionals is critical to prevent possible challenges and expensive assessments by the IRS. ■

References

American Academy of Family Physicians v. U.S., US Dist. Court, Western District Mo., West Div., 92-0644-cv-w-2, 8/96.

*Haber, Jeffry R., "The Nonprofit Advantage: Fire Or Smoke?", *Nonprofit World*, March-April 1997.

*Haber, Jeffry R., "Nonprofit Competition with Small Business: A Roadmap Leading to Answers," *Nonprofit World*, May-June 1994, pp. 14-18.

Hasselback, J. R., and R. L. Clark, "Colleges, Commerciality, and the Unrelated Business Income Tax," *Taxes*, May 1996, pp. 335-338.

Internal Revenue Code of 1986, Sec. 501(c), Sec. 513, and Sec. 401(a).

*Millman, Judith, "Unfair Competition? The Answer Will Shape Nonprofits' Future," *Nonprofit World*, July-August 1989.

*Muehrcke, Jill, *Law & Taxation*, *Leadership Series*, *Vol. I & II.*

Revenue Act of 1950, P.L. 814, 81st Congress, 2nd Session.

Trinidad v. Sagrada Orden de Predicadores, 1 USTC, Sec. 88, 263 US 578 (1924).

*Starred publications are available through the Society for Nonprofit Organizations' Resource Center. For ordering information, see the Society's *Resource Center Catalog*, beginning on page 24 of this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).

John R. Leavins is Fiesta Mart Professor of Accounting at the University of Houston-Downtown, One Main Street, Houston, Texas 77002-1001. He has a Ph.D. in accounting from the University of Houston and is a CPA in both Tennessee and Texas. He teaches in the area of taxation and has numerous publications in accounting and taxation journals. He also has many years' experience in public accounting and industry.

Darshan Wadhwa is associate professor of accounting at the University of Houston-Downtown in Houston, Texas. He has a D.B.A. in accounting from Louisiana Tech and is a CPA in the state of Texas. He has published numerous taxation articles in various professional journals and has many years of practical experience in the area of taxation. He has also served as a consultant to a number of companies in tax related matters.

Nonprofit World • Volume 16, Number 5
September/October 1998
Published by the Society for Nonprofit Organizations
6314 Odana Road, Suite 1, Madison, WI 53719 • (800) 424-7367