An Overview of Unrelated Business Income

LORMAN®

Published on www.lorman.com - January 2018

An Overview of Unrelated Business Income

The rules that govern non-profit organizations make it possible for those organizations to earn income that is simply not related to their core mission. Generally, that's because nonprofits engage in a number of diverse activities every year for outreach and fundraising purposes that are distinctly different form their overall mission in the marketplace. When these activities yield income for the nonprofit organization, it's known as "unrelated business income." The name itself refers to income from unrelated business. It does refer to "business income." This common misconception can help clear up many of the misunderstandings that occur regarding the income earned by nonprofits and charitable organizations in the United States.

One of the quirks of unrelated business income is that it typically leads to a different kind of taxation for the nonprofit that earns this type of income through its various activities in the communities. Most charitable organizations will require the services of an accountant or tax professional in order to manage this kind of income, but that's not really necessary. With a clearer understanding of how unrelated business income is defined, where it comes from, and how it's taxed, many nonprofit organizations can actually skip the accountant and more easily handle their own finances.

Unrelated Business Income: What it is

The entire purpose of defining income as either related to the nonprofit's fundraising efforts or separate from those efforts is so that the government can tax the income. Because charitable organizations are exempt from virtually all federal taxes, the income raised in order to keep the lights on, keep outreach going, and provide services, is considered to be "related" business income. This income is claimed and stated on federal tax returns, but the government does not tax it at all.

If activities exist outside of what could be considered essential to the nonprofit organization's operations and its overall purpose, that income is considered unrelated. Any amount of this unrelated business income is then taxed by the government at a standard rate, and charitable organizations will usually have to pay a small amount of that income back into the system via their federal tax return and other documents at the end of the fiscal year.

Specifically, the federal government considers three conditions when seeking to determine whether or not the income brought in by a charitable organization is related or unrelated.

Unrelated business income is defined in the following three ways:

1. The income is the result of a trade or business that is operated by the charitable organization, but remains separate from that organization

2. The business activity that generates the income is operated on a regular, ongoing basis, and is not operated seasonally or infrequently

3. The income is generated by activity or businesses that are not significantly related to the tax exempt purpose of the charitable organization as decided by the law and declared by the company's charter

Any and all income that meets the three above guidelines will be considered unrelated business income, and it will need to be claimed on federal tax returns. A base tax rate will apply to that income, though the tax rate is variable and is generally determined by the Internal Revenue Service based on the total amount of unrelated business income earned by the charitable organization during the preceding calendar year.

What Type of Organization Can Earn Unrelated Business Income?

The most common type of organization that is subject to federal laws governing unrelated business income and the taxes that apply to that income are 501(c)(3) charitable organizations and nonprofit organizations registered under several different parts of the financial code in the United States. These organizations all apply for tax exempt status and any tax exempt entity must understand that its for-profit operations will incur taxes levied by the Internal Revenue Service.

In addition to the 501(c)(3) status of charitable organizations and the tax exempt status of other nonprofits under United States financial regulations, all colleges and universities are governed by these same regulations and they must report all unrelated business income to the Internal Revenue Service on an annual basis as part of their tax filing with the agency.

Charitable organizations, universities, and nonprofits, should all be sure to avoid earning a significant amount of unrelated business income over the course of any year, as this can place other organizational characteristics into jeopardy with the Internal Revenue Service and federal regulators who monitor the source, type, and amount, of this income.

A Common Example: Understanding Unrelated Business Income

The easiest way to understand unrelated

business income is to consider how it's typically generated. Most charitable organizations earn a large amount of their money by charging memberships to their most enthusiastic supporters. Those memberships come in several tiers, all of which serve to fund the organizations operations throughout the calendar year. As part of its mission to stay relevant in the community, the organization also runs a daycare within its facility in the community.

The daycare operated by the charitable organization charges a monthly membership fee that does not go toward the cost of the organization's operations or its continued existence in the community. Instead, that money is actually used merely to support the daycare and pay the employees who watch children while the facility is open. While the membership fees are "related" income that is used to keep the charity funded and solvent, the daycare income is "unrelated" because it does not serve to keep the charity's doors open in any meaningful way.

At the end of the calendar year, when taxes come due, the charitable organization will claim its membership fee structure as charitable income that allowed it to keep performing activities in the local community. It will claim its daycare income as unrelated business income, and it will pay a percentage-based tax on that income to the federal government at the time the tax return is filed. It's easy to see how the daycare itself is actually a business, as its fees directly cover the daycare's expenses and salaries rather than the charity's own operating expense and outreach activities. Furthermore, money raised at the daycare pays a salary whereas the income raised by charities typically does not pay its all-volunteer group of organizers.

How to Make the Daycare into a Source of Related Business Income

If the income from the daycare is to be untaxed by the federal government, then the changes made to the program must ensure that the profits earned by the program are used for slightly different purposes. Generally, the federal government does not consider unrelated business income to arise from operations that are performed by volunteers, no matter the goals and nature of those operations. It also does not consider unrelated business income to arise from activities that are designed to benefit a group of people who are in need, such as disabled individuals, senior citizens, or the unemployed.

Federal guidelines permit income earned in various ways to actually navigate a series of regulations, making it into traditional nonprofit earnings that will avoid federal tax rates. In the example above, several key changes could be made to turn the program from one that qualifies for federal tax collection to one that does not require any amount to be paid back to the government via the Internal Revenue Service.

Change 1: Daycare Employee Salaries Would be Eliminated

Federal regulations are much more friendly to programs that employ an all-volunteer work force than they are to those that pay a salary. In terms of unrelated business income, nonprofit organizations can escape government taxation simply by hiring volunteers to watch children throughout the day. Their services will be unpaid, but their presence will allow the organization to eliminate a significant financial burden on its annual taxes each year that it files.

Change 2: Proceeds Should Benefit a Group in Need

Who needs daycare services? If the daycare was meant to benefit the unemployed who are looking for jobs, or single mothers who need to work two jobs to provide for their children, then it would generally escape virtually every definition of unrelated business income. In this case, the daycare turns from a source of profit to a source of outreach, interacting with the community and helping some of its most vulnerable members improve their own financial situation and their standing in the community. Any profits that were earned as part of the program would then be considered part of the organization's endowment, rather than part of its unrelated business income and profits.

Other Examples of Profits that Are Not Unrelated Business Income

Nonprofit organizations can actually be quite active in the community in terms of buying and selling things, all without incurring the expense of the unrelated business income tax levied by the Internal Revenue Service. A few examples of this include:

- A store that sells items that have been donated to the organization by members of the community for the specific purpose of resale. Excellent examples of this include Goodwill stores across the country as well as the thousands of Salvation Army stores that exist all around the world. At these stores, it is assumed that the donations are taken at no cost, and their sole purpose is to help the charitable organization boost its own endowment. Essentially, government regulators see those donations as a form of financial donation to the organization, even though it will have to work on its own to turn them into real income.

- Incentives that are distributed to potential donors in order to get them to commit to a contribution to the organization. In the same vein, incentives mailed out to those people who have already donated to the nonprofit organization are viewed as a source of "related" business income that will not force the company to be taxed by the IRS. In the eyes of the government, these incentives are encouraging donations that are essential to the organization's fiscal survival. Therefore, even though they may generate profits in the form of contributions, their income is directly related to the organization's activities and long-term survival in the community. It should be noted, though, that these incentives must be worth less than $5 individually. If not, any amount over the $5 benchmark will be eligible for taxation by the government at the end of the calendar year.

- Allowing other organizations to rent a mailing list of the organization's donors and members is not considered to be unrelated business income. Instead, this type of information sharing is considered to be beneficial to the purposes of both organizations engaging in the exchange, and any profits generated from the exchange of this information are generally termed to be related to the activities of both participating organizations.

- If the amount of unrelated business income earned in any calendar year is less than $1,000, it does not need to be declared or filed with the Internal Revenue Service. That means that it simply will not be taxed at all, as the IRS does consider such a small amount to be relatively negligible in terms of the benefits it affords nonprofits and the enhanced revenue that it might provide to the federal government upon taxation and collection.

Plenty of Ways to Engage without Encountering Taxation

The list above is an example of the many ways that the government actually encourages nonprofits to engage in business-like activities merely to ensure their own survival. Just because the term "unrelated business income" has the word "business" in it, nonprofits should not be afraid to operate like a business and undertake business activities that can ensure the survival of their charitable outreach programs and the many benefits that they afford to members of the local community.

Before proceeding with any such activity, though, consult federal guidelines about income and how it may qualify for taxation by the Internal Revenue Service at the end of the year. If in doubt, consult a legal professional or a trusted accountant who will be able to provide a clearer picture about what can be done, and what might be taxed, under these regulations.

Understand the Potential Impact on 501(c)(3) Status

In the United States, the rules that govern charitable income and business profits are part of the larger business code. The specific type of organization that is declared exempt from federal taxes is known as 501(c)(3), which might sound familiar to anyone who has donated to an organization or listened to its disclaimers about its income and operations. To qualify for this status, organizations go through a long checklist of documents and statements that assure the government their operations are within the law and not designed to earn a significant profit.

That being said, though, the government does clearly understand that some amount of unrelated business income will be earned by these organizations. The IRS did, after all, create a special tax program that applies specifically to this type of income when it is earned by a charitable or nonprofit organization. It's certainly no problem for nonprofit organizations to file their yearly taxes with regular statements of unrelated business income that exceed the non-taxable $1,000 threshold. After several years of this activity, though, government officials might begin to reconsider the 501(c)(3) licensing status that characterizes the organization.

If a significant amount of unrelated business income is reported by the organization year after year, a special part of the nonprofit organization regulations actually allow the government to revoke that license and suggest instead that the operation be run more as a traditional business with a corporate structure and a much higher tax burden. For this reason, it is very important for nonprofits to earn the vast majority of their endowment form related activities and charitable work in the community. An excessive amount of unrelated income over a long period of time will likely lead to bigger organizational and fiscal problems that could have a severe impact on just how effective the nonprofit is at reaching out to the community.

How to Document and File All Unrelated Business Income

Documenting the sources and total amount of unrelated business income is actually rather simple Nonprofit organizations, charities, and universities, simply need to add Internal Revenue Service Form 990T to their list of forms to fully complete and submit during tax season. This form will ask for the total amount of income earned from business activities that are carried on regularly, even though they are not related to the organization's purpose or their place in the community.

If that income reaches a certain amount, as determined by an equation present on Form 990%, then the organization will have to pay taxes on that income at a rate that will be determined by the amount of unrelated business income earned. the higher the amount earned by the charitable organization or university, the higher the tax rate will generally be when calculated by the IRS.

As always, be sure to fully document the uses of all income generated, the purpose of all profits earned, and the ways in which that income might qualify as nontaxable. Typically, this will require extensive documentation and the help of leading professionals in the field.

Consult a Lawyer or Accountant if in Doubt about Earnings and Taxation

Nonprofit organizations shouldn't risk their sterling tax status with the federal government when it comes to documenting their unrelated business income. The unrelated business income tax levied by the Internal Revenue Service is a big deal in the eyes of federal regulators and the implications of seeking to subvert its collection can be damaging to charities and universities alike.

A failure to fully report all earnings for the year, even those that are not related to the organization's endowment and daily operations can jeopardize the 501(c)(3) licensure enjoyed by the organization. That organization can then be threatened with closure or steep financial penalties due to the IRS.

It's not impossible to file a federal tax return for the organization that properly states the income earned from unrelated business activities, and many smaller organizations can probably do this on their own using the simple Form 990T that is distributed by the IRS to nonprofits each year. For larger organization with more complex operations and earnings, though, it might be a good idea to invoke the help of a professional accountant or tax expert who can determine how to best claim that income and avoid the highest taxation rates levied by the government. In some cases, a lawyer may also be able to help with this process while providing the right advice for the organizations' continued fiscal solvency.

When in Doubt, Stick to Traditional Nonprofit Activities

The best way to avoid the hassles that come with significant amounts of unrelated business income is simply to stay away from activities that are more closely aligned with business than they are with charity, academia, or the activities of traditional nonprofit operations. With careful planning, it's actually quite easy for these organizations to increase their operating budget and reduce their expenses without resorting to activities that are distinctly corporate in nature.

If business-like activities are pursued by the nonprofit organization, it's a good idea to monitor the amount of income being generated and strive to keep it under the $1,000 taxation threshold that is currently required by the IRS. Doing so will at least eliminate the requirement to file and the payment of any taxes as part of the agency’s unrelated business income tax that has become quite dangerous in recent years.

Pay Attention and Be Thorough, and the Tax Won't Be an Issue

As always those in charge of nonprofit organizations should remember to always pay attention to how their organization is operating each segment of its outreach business. Focus on hiring volunteers, make sure that all raised income has a purpose in the community, and remember that a nonprofit organization should always be making investments in its community, its members, and its endowment, and not in its profitability alone.