MONETIZING YOUR ACTIVITIES: IS IT TAXABLE?

Making money is a good thing, right? A tax-exempt organization generally does not pay taxes on its income, whether that income is from dues, donations, investments, or sale of certain goods and services. A tax-exempt organization does pay taxes on its unrelated business income—income from activities unrelated to its exempt purpose. An organization with $1,000 or more of gross income from an unrelated business must file Form 990-T and pay tax at the current corporate tax rate. This tax is commonly referred to as UBIT.

Tax-exempt organizations that are hungry for revenue to offset shrinking donations, dues, or grants should understand upfront how the unrelated business income rules work in order to avoid a large tax bill (with interest and penalties)—or, in the extreme case, loss of exempt status if the IRS finds the organization's primary purpose has become conducting a for-profit commercial activity.

The Rule

In general, an activity is an unrelated business and subject to UBIT if it meets three requirements:

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

The first two prongs are fairly straightforward. The last prong is the gray area. "Not substantially related" means the activity that produces the income does not contribute importantly to the exempt purpose of the organization (aside from the organization's need for income or the use it makes of the profits to further its exempt purpose). Whether an activity contributes importantly to the organization's purpose depends on the facts. The IRS looks at the size and extent of the activities involved in relation to the nature and extent of the exempt function that they intend to serve.

Many organizations sell goods or perform services that contribute importantly to the organization's exempt purpose. How much an organization charges (below cost) and to whom it sells (members only or the public) are factors the IRS will consider in determining whether an activity is related or unrelated to mission. Bear in mind, an organization can engage in some business activity as long as this is not its primary activity.

The Exceptions

The Tax Code contains a number of exceptions to unrelated business income that allow tax-exempt organizations to earn nontaxable income outside of donations, dues, and grants. For example, dividends, interest, certain rental income, gains or losses from the disposition of property, royalties, and certain qualified sponsorship payments are common exceptions that are nontaxable. Note of caution: The exclusions for interest, royalties, and rents may not apply to a payment of these items from a subsidiary organization to its parent organization.

Royalties. A significant source of revenue for many tax-exempt organizations is royalty income. To be considered a royalty, a payment must relate to the use of a valuable right. Payments for trademarks, trade names, or copyrights are ordinarily considered royalties.

In a typical scenario, an organization agrees to license its name and logo to a company in connection with the sale of that company's goods or services. An organization can maintain the right to review and approve materials and licensed products bearing its name and logo. However, the IRS views payments for endorsements or active involvement in the development of any materials as taxable payments for personal services and not royalty payments. Separate agreements—or, at a minimum, separate payments for the reimbursement of services provided to the licensee—are critical to ensure that the royalty income from a license arrangement remains nontaxable.

Sponsorships. Another significant source of revenue for many tax-exempt organizations is sponsorship income. A qualified sponsorship payment is a payment made by a person engaged in a trade or business for which the person will receive no substantial benefit other than the use or acknowledgment of the business's name, logo, or product lines in connection with the organization's activities.

There is an important caveat, however: payments for qualitative statements or endorsements of the sponsor's goods or services are taxable. Therefore, it's a best practice to have separate agreements or separate payments for sponsorships, endorsements, and advertising or other benefits given to a sponsor above a certain value. This helps the organization keep track of the various nontaxable and taxable payments and provides support if your organization is ever audited by the IRS.

Areas of Scrutiny

The IRS has recently signaled that Form 990 audits based on underreporting of unrelated business income and offsets of large losses are coming. Congress also has its eye on the seemingly commercial nature of many tax-exempt organizations and could look to tighten some of the unrelated business income rules as part of a broader corporate tax reform package. Draft tax reform legislation proposed last year by then-Chairman Dave Camp (R-MI) of the House Ways and Means Committee included a number of UBIT-related provisions, including these:

- Any sale or licensing by a tax-exempt organization of its name or logo would be treated as a per se unrelated trade or business, and royalties paid with respect to such licenses would be subject to UBIT.
- Any mention of a sponsor's product lines would turn a nontaxable sponsorship payment into taxable advertising income.
- New penalties would be imposed on officers, directors, or responsible employees for any substantial understatement of unrelated business income tax.

* * *

Sarah E. Mooney | smooney@wc-b.com | 202-785-9500