UBIT: A COMPREHENSIVE OVERVIEW FOR NONPROFITS

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This article provides an overview of the basic UBIT rules and examines three key exceptions to UBIT.

While most income of nonprofit, tax-exempt organizations is exempt from federal and state corporate income tax, certain income of nonprofits is subject to tax — a tax known as the unrelated business income tax ("UBIT"). The rules governing UBIT are complex and confusing. This article provides an overview of the basic UBIT rules and examines three key exceptions to UBIT that enable nonprofits to strategically plan to maximize their revenues and minimize their income taxes.

Background

Nonprofit, tax-exempt organizations (hereinafter referred to as nonprofits) are granted a general exemption from federal corporate income tax by the IRC for income from activities that are substantially related to the purposes for which the nonprofit's tax-exempt status was recognized by the IRS. Nevertheless, they are potentially taxable for income derived from unrelated business activities. The IRC defines an unrelated trade or business as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income…) to the exercise or performance by such organization of its… purpose or function constituting the basis for its exemption…"

The tax on unrelated business income first appeared in the IRC in 1950. The principal purpose of Congress in enacting UBIT was to provide a level competitive playing field for tax-paying businesses, so that tax-exempt organizations could not use their privileged tax statuses to unfairly compete with tax-paying businesses in activities unrelated to their purposes. However, instead of prohibiting tax-exempt entities from engaging in any business activities at all (and denying or revoking tax exemption because of such activities) — which it had considered doing — Congress chose to specifically permit a certain degree of business activity by tax-exempt organizations but tax that activity like any other for-profit business. Thus, such business activities are permissible, so long as the activities are not a "substantial part of [the nonprofit's] activities."[1] The tax applies to virtually all tax-exempt entities. The most common form of unrelated business income for nonprofits, by far, is advertising income (e.g., in periodicals, on websites, and on social media).

UBIT is imposed at the 21 percent flat federal corporate income tax rate. Deductions are permitted for expenses that are "directly connected" with the carrying on of the unrelated trade or busi-

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ness, and net operating losses are allowed to be carried forward and backward (with certain limitations). Losses from one unrelated business activity are not able to offset gains in another; profits and losses are determined per activity.

Three-pronged UBIT test. It is important to note that not all business income is subject to taxation or to limitations — only "unrelated business income" as defined in the IRC. Unrelated business income will only exist if three conditions are satisfied; if any one of the three is not present, income from the activity will not be taxable. Unrelated business income must be:

- from a trade or business;
- regularly carried on; and
- not substantially related to the purposes that form the basis of the organization's tax-exempt status.

Exclusions. Even if all three conditions of the UBIT test are satisfied, there are numerous statutory exclusions both (1) from the definition of an unrelated trade or business and (2) in the computation of unrelated business taxable income, which can exempt otherwise taxable income from UBIT. Many such exclusions are potentially applicable to nonprofits, although many are not. The most relevant exclusions for nonprofits typically include:

- qualified corporate sponsorship income;
- royalties;
- qualified convention or trade show income;
- interest, dividends, annuities, and certain capital gains;
- certain rental income; and
- volunteer labor exception.

Taxable subsidiaries. If the gross revenue, net income, and/or staff time devoted to unrelated business activities become "substantial" in relation to the tax-exempt functions of a nonprofit (thereby jeopardizing its tax-exempt status), the nonprofit can "spin off" one or more of the unrelated activities into a separate, but affiliated, wholly owned entity, commonly referred to as a taxable subsidiary. Such a taxable subsidiary will pay corporate income tax on its net income but can remit the after-tax profits to the parent nonprofit as tax-free dividends. However, the dividends are not tax-deductible for the taxable subsidiary as business expenses.

Note that there is a significant tax advantage to housing unrelated business activities in a taxable subsidiary. For tax-exempt organizations, the expenses of a particular unrelated business can only be used to offset the gross unrelated business income of that particular unrelated business in calculating net income and the corresponding UBIT. However, if the same activities are conducted in a taxable subsidiary, all of the subsidiary's expenses can be used to offset its gross income before any corporate income tax is imposed on its overall net income. This means that losses from one activity can be used to offset gains from another activity.

Filing and payment requirements. In computing UBIT, a specific deduction of $1,000 is permitted. If a nonprofit has a gross unrelated business taxable income of $1,000 or more during its fiscal year, it must file IRS Form 990-T to report such income and pay any tax due. The Form 990-T is

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due at the same time as the Form 990. However, if a nonprofit expects its annual UBIT (after certain adjustments) to be $500 or more, then it must make estimated tax payments throughout the year. The Form 990-T is subject to public disclosure like the Form 990; however, certain schedules, attachments, and supporting documents that do not relate to the imposition of UBIT do not have to be made available for public inspection.

Corporate sponsorships

Overview. "Qualified corporate sponsorship payments" are excluded in computing the unrelated business taxable income of tax-exempt nonprofits. A "qualified sponsorship payment" is defined as "any payment [of money, property or services] by any person engaged in a trade or business

[1] "UBIT: A Comprehensive Overview for Nonprofits," Tennenbaum Law Group PLLC (September 7, 2021). Available at: https://www.tenenbaumlegal.com/articles/ubit-a-comprehensive-overview-for-nonprofits

with respect to which there is no arrangement or expectation that the person will receive any substantial return benefit."[2] In determining whether a payment is a qualified sponsorship payment, it is irrelevant whether the sponsored activity is related or unrelated to the recipient organization's tax-exempt purposes. It also is irrelevant whether the sponsored activity is temporary or permanent.

Definition of substantial return benefit. A "substantial return benefit" is defined as any benefit other than: (1) goods, services, and other benefits of "insubstantial value" or (2) a "use or acknowledgment." A substantial return benefit includes:

Royalties are excluded in computing the unrelated business taxable income of tax-exempt organizations.

- advertising;
- providing facilities, services, or other privileges to the sponsor (or persons designated by the sponsor), unless such privileges are of "insubstantial value";
- granting the sponsor (or persons designated by the sponsor) an exclusive or nonexclusive right to use an intangible asset (e.g., name, logo, trademark, copyright, or patent) of the tax-exempt organization (note that although payment for providing a sponsor with the right to use such an intangible asset will not constitute a qualified sponsorship payment, it may constitute a tax-free royalty); or
- designating a sponsor as an "exclusive provider."

Insubstantial value. Goods, services or other benefits of "insubstantial value" are those that have an aggregate fair market value of not more than 2 percent of the amount of the payment. Note that if the fair market value of the benefits exceeds 2 percent, the entire fair market value (as opposed to the cost) of such benefits, and not merely the excess amount, is considered a substantial return benefit.

Use or acknowledgment. A substantial return benefit does not include a "use or acknowledgment" of the name or logo (or product lines) of the sponsor's trade or business in connection with the activities of the tax-exempt organization. Use or acknowledgment does not include advertising but may include:

- sponsor logos and slogans that do not contain qualitative or comparative descriptions of the sponsor's products, services, facilities, or company;
- a list of the sponsor's locations (e.g., street addresses), telephone numbers, or website URLs;
- value-neutral descriptions (including displays or visual depictions) of the sponsor's product line(s) or services;
- sponsor brand or trade names and product or service listings; and
- designating a sponsor as an "exclusive sponsor."

Logos or slogans that are established parts of the sponsor's identity are not considered to contain qualitative or comparative descriptions. Mere display or distribution (whether for free or for remuneration) of a sponsor's product by the sponsor or the tax-exempt organization to the general public at a sponsored activity will not be considered an inducement to purchase, sell, or use the sponsor's product. Thus, it will not impact the determination as to whether a payment constitutes a qualified sponsorship payment.

Advertising. "Advertising" is defined as any message or other programming material that is broadcast or otherwise transmitted, published, displayed, or distributed and that promotes or markets any trade/business, service, facility, or product. Advertising includes:

- messages containing qualitative or comparative language;
- price information or other indications of savings or value;
- an endorsement; or
- an inducement to purchase, sell, or use any company, service, facility, or product.

A single message that contains both advertising and an acknowledgment is considered advertising. The aforementioned rules do not apply to activities conducted by a sponsor on its own.

Royalties

Overview. Royalties are excluded in computing the unrelated business taxable income of tax-exempt organizations. This exclusion does not apply to debt-financed income or to royalties received from a "controlled subsidiary." The IRS defines a "royalty" as any payment received in consideration for the

[2] *Ibid.*
[3] *Sierra Club, Inc. v. Comm'r I.R.S.,* 86 F.3d 1526 (9th Cir. 1996).
[4] Rev. Rul. 81-178, 1981-2 C.B. 135.

use of a valuable intangible property right, whether payment is based on the use made of the intangible property or not. Payments for the use (even on an exclusive basis) of trademarks, trade names, service marks, copyrights, photographs, facsimile signatures, and members' names are ordinarily considered royalties and are tax-free. However, payments for services (such as marketing or administrative services) provided in connection with the granting of this type of right are not royalties, and they are generally taxable as unrelated business income (unless such services are substantially related to the nonprofit's purposes, and in most cases, they are not).

Examples. In an example provided by a Federal Appeals Court in the *Sierra Club* case, if the Sierra Club manufactured and sold T-shirts with the organization's logo or other designs on them, the income earned from the sale of such T-shirts would be taxable, as the activity of manufacturing and selling T-shirts is not substantially related to the Sierra Club's tax-exempt purposes. However, if the Sierra Club created the designs to be screened onto the T-shirts — and then licensed those designs to a T-shirt manufacturer in exchange for a fee (perhaps calculated as a percentage of gross T-shirt sales) — that income would constitute tax-free royalty income.[3]

In an example provided by the IRS in a revenue ruling, payments for the use of a professional athlete's name, photograph, likeness, and/or facsimile signature (provided by and through a tax-exempt organization) are generally considered royalties. However, payments for personal appearances and interviews by the athlete (similarly provided by and through a tax-exempt organization) are not excluded as royalties and must be included as income from an unrelated trade or business.[4]

Endorsements. When a nonprofit endorses a vendor's product or service (often referred to as a nonprofit "affinity" program) but does nothing to market the product or service to its members (leaving this task to the vendor), this can be viewed as, in essence, nothing more than an exclusive license of the nonprofit's name, logo, and (sometimes) membership list to the vendor (in connection with the vendor's promotion and sale of that product or service to the nonprofit's members and possibly also to others in the industry or profession). As stated previously, if the nonprofit gets paid for this exclusive license — even if such payments are calculated as a percentage of gross sales of the endorsed product or service to the nonprofit's members — then the payments will constitute royalties and will be tax-free to the nonprofit. If, however, the nonprofit does market the product or service to its members, then the tax issues become more complex, as described in the following sections.

Endorsements can be a useful means for nonprofits to generate nondues revenue from both members and nonmembers; promote the nonprofit's name and brand and, by extension, the industry or profession in general; and provide a service (e.g., "tailored" products and services, dis-

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counted rates/fees, and so forth) to nonprofit members.

Options for structuring endorsement arrangements. These options include the following:

Royalties only. The endorsement or licensing contract that carries the lowest risk of UBIT liability is one in which the nonprofit licenses its name, logo, and/or membership list; exercises quality control over the use of its intangible property by the vendor; and does not do much more. However, even under this scheme, the IRS and the courts have indicated that the nonprofit may engage in certain limited activities without jeopardizing the tax-free royalty treatment of its income.

Endorsements can be a useful means for nonprofits to generate nondues revenue from both members and nonmembers; promote the nonprofit's name and brand and, by extension, the industry or profession in general; and provide a service (e.g., "tailored" products and services, discounted rates/fees, and so forth) to nonprofit members.

Royalties to nonprofit; Services income to a third party or taxable subsidiary. If administrative and/or marketing services are required, from a tax perspective, it is generally preferable to outsource such services to an unrelated third party or to the nonprofit's taxable subsidiary (with the nonprofit and subsidiary entering into separate, independent contracts with the vendor). In a 1999 private letter ruling issued to the AARP (Ltr. Rul. 200149043), the IRS validated the use of an AARP-wholly owned taxable subsidiary to provide such administrative and/or marketing services, provided it was done on an arm's length basis (e.g., fair market valuation of the payments to each entity, financial separation, employee time records, and so forth).

Royalties to nonprofit; services income to nonprofit. If such services must be provided by the nonprofit directly, then nonprofit contracts with the vendor should provide for separate, distinct provisions of the contract — one for the name, logo, and/or membership list licensing on the one hand, and one for the administrative and/or marketing services. The fees earned by the nonprofit should be divided between the two sections pursuant to a fair market valuation. The former should be treated as tax-exempt royalty income; the latter, meanwhile, should be treated as taxable unrelated business income.

Convention and trade show income

Background. Since 1976, one of the IRC's exceptions to unrelated business taxable is for income received from "qualified convention and trade show activities." In order to qualify for the safe harbor exception, the nonprofit must "regularly conduct as one of its substantial exempt purposes a show which stimulates interest in, and demand for, the products of a particular industry or segment of an industry or which educates persons in attendance regarding new developments or products and services related to the exempt activities of the organization."[5] The exception applies to 501(c)(6) tax-exempt entities, as well as to 501(c)(3), (c)(4), and (c)(5) organizations. Prior to 1976, the IRS had started to treat nonprofits' trade show exhibit fees as subject to UBIT, arguing that such fees were akin to taxable advertising income. Note that these UBIT issues generally do not apply to most of the convention activities of nonprofits that are not trade show related — such as the provision of educational content — as such activities are usually substantially related to the tax-exempt purposes of the nonprofit.

2004 IRS Revenue Ruling 2004-112. In 2004, the IRS issued Revenue Ruling 2004-112 on the subject of virtual trade shows. With the then-increasing prevalence of the internet and the ability to offer virtual trade shows, questions began to arise as to whether the offering of a web-based trade show was the type of activity that was "of a kind traditionally conducted at ... trade shows," as quoted from Section 513(d) of the IRC.[6] The guidance describes two hypothetical scenarios: One involves a Section 501(c)(6) nonprofit that offers a semiannual virtual trade show in connection with each in-person trade show, and the other involves a Section 501(c)(6) nonprofit that offers a virtual trade show not in relation to any in-person one.

Revenue Ruling 2004-112 made clear that the key factor in the analysis of whether virtual trade show activity will be considered subject to the IRC's safe harbor is whether or not the virtual show is conducted ancillary to a live show.

In the first hypothetical scenario, a nonprofit conducts two trade shows per year. In conjunction with such shows, the nonprofit has a separate virtual trade show section of its website available for viewing at all times during such shows, as well as for three days preceding and three days following such shows. The in-person shows in this first scenario are similar to most trade or professional nonprofit shows — they include members of the nonprofit and suppliers to the industry, and exhibitors are charged a fee by the nonprofit in order to participate. The website contains "information and visual displays…and links to the websites of exhibitors represented at the [in-person] trade show."[7] The website also contains order forms and a function that allow online purchases from exhibitors. The nonprofit charges a fee to exhibitors who desire to have information listed on this web page.

According to the IRS, the virtual activities described previously fit within the safe harbor for qualified convention and trade show activities because:

- The web activities are "ancillary" to the in-person trade shows.
- The content of the web section serves to "augment and enhance" the in-person trade shows by making available "in an alternative medium the same information available at the show."[8]
- The web page is available "during essentially the same limited time period that each trade show is in operation."[9]

Thus, income generated by the web page will not be subject to UBIT in this scenario.

The second hypothetical scenario provided by the IRS is very similar to the first, except that the organization in the second scenario offers virtual trade shows that are two weeks long without any connected in-person events. According to the IRS, such activity will not qualify for the safe harbor. The IRS reasons that the website in this example is "not itself a convention, annual meeting or trade show" within the meaning of the IRC, due to the lack of an in-person, face-to-face component.[10]

Current-day virtual trade shows. Fast-forward to 2022. The virtual trade shows of 2022 — compared to 2004 — are much more interactive. As known by those nonprofits who have had to transition over the past couple of years from in-person conferences and trade shows to virtual (or hybrid) ones due to the COVID-19 pandemic, the educational and networking aspects of these virtual trade shows were notable and done in a way that was not possible in 2004. Today's virtual conferences and trade shows resemble, in many respects, their in-person counterparts for which the safe harbor was written. However, with no guidance from the IRS since 2004, it is very difficult to say how the IRS would interpret the safe harbor today and apply it to the 2022 virtual (or hybrid) trade show.

Hybrid trade shows. Due to the COVID-19 pandemic, it is likely that at least for 2022, and perhaps into 2023, nonprofits will plan to hold many hybrid in-person and virtual conferences and trade shows. The virtual trade show in the first example of Revenue Ruling 2004-112 features only "the same information that is available at the [in-person] show" and a function that allows purchases from "members and suppliers represented at the trade show."[11] However, if a nonprofit were to offer a virtual show in connection with a live show — and were to allow companies not exhibiting at the live show to participate in the virtual show — would this cause the IRS to determine that the virtual show was no longer "ancillary" to the live show and thus not able to qualify as part of the safe harbor? It is simply unclear, as is the application of Revenue Ruling 2004-112 to the modern-day virtual-only or hybrid trade show.

Today's virtual conferences and trade shows resemble, in many respects, their in-person counterparts for which the safe harbor was written.

No safe harbor does not necessarily mean UBIT. It should be noted that a failure to qualify for the safe harbor does not necessarily mean that the income generated from a virtual trade show will be subject to UBIT. In most instances, the IRS likely would take the position that the net income is generated by the sale of advertising-type services and thus is subject

5 "UBIT and Virtual Tradeshows: What Associations Need to Know," ASAE (March 1, 2021). Available at: https://www.asaecenter.org/resources/articles/an_plus/2021/march/ubit-and-virtual-tradeshows-what-associations-need-to-know.

6 IRS Revene Ruling 2004-112

7 "IRS Issues 'Virtual' Trade Show Guidance," Venable LLP (January 2005). Available at: https://www.venable.com/insights/publications/2005/01/irs-issues-virtual-trade-show-guidance.

8 *Ibid.*

9 *Op. cit.* note 6.

10 *Ibid.*

11 IRS Revenue Ruling 2004-112

to UBIT. However, there may be instances when a nonprofit is able to demonstrate that its activity is substantially related to its tax-exempt purposes, even without the help of the safe harbor. Furthermore, if the arrangements with otherwise-exhibiting companies are restructured accordingly, other IRC exceptions from UBIT — such as exceptions for corporate sponsorship payments and royalties — may apply to some or all of the income in question.

Conclusion

The analysis of whether and how the safe harbor applies to current-day virtual or hybrid trade shows is as clear as mud; still, the ongoing fallout from the pandemic will continue to force nonprofits to consider alternatives to in-person-only conferences and trade shows. The existence of Revenue Ruling 2004-112 — unless and until it is modified by the IRS, which will not likely be anytime soon — will continue to pose UBIT risks to nonprofits in the virtual or hybrid trade show environment.

That being said, Revenue Ruling 2004-112, although on the books, does not supersede the clear intent of the IRC: to provide a safe harbor exception to unrelated business income where a nonprofit conducts an event to educate persons or stimulate interest and demand for products or services of the membership. Therefore, it arguably may not matter whether the activities traditionally conducted at trade shows are done in person or virtually. It would certainly be helpful if the IRS were to provide guidance in a new and updated revenue ruling. Until then, it would be advisable to document how the activities of the trade show meet the IRC definitions of the safe harbor.

While paying UBIT is certainly not a bad thing — and nonprofits generally should not let the federal tax laws be the tail that wags the dog — having a thorough understanding of the rules in this area can help nonprofits to plan strategically and attempt to mitigate UBIT to the greatest extent possible. ■