



Nonprofit & Tax-Exempt Organizations Update:  
**Is Your Tax-Exempt  
Organization Subject to UBIT?**

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Sometimes the correct answer to the question is “Who the heck knows?”

Tax-exempt organizations are generally aware that they may be subject to the unrelated business income tax (UBIT) on income derived from certain types of activities, despite being recognized by the IRS as organizations that are otherwise exempt from income tax under Section 501(c)(3) or under other provisions of U.S. Internal Revenue Code Section 501(c). Whether the UBIT applies in a particular instance or to a particular activity, however, may not always be clear.

**WHEN IS A TAX-EXEMPT ORGANIZATION SUBJECT TO THE UBIT?**

The test of when a tax-exempt organization is subject to the UBIT is easy to state: A tax-exempt organization is subject to the UBIT if it derives income from (i) a trade or business that (ii) is regularly carried on by the organization, and (iii) is not substantially related to the organization’s tax exempt purpose.

Despite this relatively simple formulation, the test is not always easy to apply. All three factors identified above must be present before an organization will be subject to the UBIT; and determining the presence or absence of some or all the factors can often be challenging.

**WHAT IS A TRADE OR BUSINESS?**

The problem begins with the first part the test, i.e., the “trade or business” requirement. The tax laws do not provide a clear definition of that term.

The UBIT regulations attempt to define “trade or business.” The specific regulation that does this provides a helpful explanation of the reason for the UBIT (“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”). It also provides some simple examples of activities that are not subject to the UBIT (e.g., “when an organization sends out low-cost articles incidental to the solicitation of

charitable contributions,” that is not subject to the UBIT). It does not, however, actually define “trade or business.” It defers instead to the definition of that term in another section of the U.S. Tax Code, Section 162, and notes that for purposes of the UBIT the term has the same meaning as under Section 162.

Unfortunately, neither Section 162 (which deals with when ordinary and necessary expenses incurred in a trade or business are deductible) nor the tax regulations issued under it further define the term. As a consequence, courts have been forced to step in and divine the meaning of that term for purposes of Sections 162 and taxpayers have been forced to comb through case law to divine what the courts divined.

The court-created definition of “trade of business” is generally workable, but not entirely satisfactory. That definition generally provides that an activity is a trade of business if the taxpayer conducts the activity with continuity and regularity, and with the primary purpose of earning income or making profit. The courts have emphasized that in applying the definition to a particular case, all the surrounding facts and circumstances must be examined. This broad definition of “trade of business,” together with the direction of courts to examine all surrounding facts and circumstances in each case, leaves plenty of room for the IRS and taxpayers to disagree on the taxpayer’s primary purpose for engaging in an activity and on whether the conduct of the activity is sufficiently continuous and regular to rise to the level of a trade of business, which leads to uncertainty in many cases and often results in tax-exempt organizations guessing whether they are subject to the UBIT.

## WHEN IS A TRADE OR BUSINESS REGULARLY CARRIED ON?

The second problem with applying the test to determine if a tax-exempt organization is subject to the UBIT lies with the requirement that the trade or business be “regularly carried on.” As with the term “trade or business,” there is no bright-line test for determining when the trade or business of a tax-exempt organization will be treated as being regularly carried on. The UBIT regulations, however, offer some general guidance.

The regulations provide that in determining whether the “regularly carried on” requirement is satisfied “regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.” If the business activities of a tax-exempt organization are generally similar to comparable commercial activities of organizations that are not tax-exempt, in terms of the activities’ frequency, continuity, and the manner in which they are pursued, then the activities will ordinarily be treated as regularly carried on.

The regulations also state that 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,” even if they are conducted on a recurring annual basis. An example of such infrequent activities might be an annual charity ball, fund raising spaghetti dinner or other similar charitable fund raising event.

Despite the helpful guidance provided by the UBIT regulations, there are many situations that they do not address. For example, in discussing the intermittent income producing activities rule, discussed in the immediately preceding paragraph, the regulations state that “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.” No further elaboration of the rule is provided, however, leaving tax-exempt organizations to guess at the meaning of the terms “short period of time” and “recur only occasionally or sporadically.” The general nature of the guidance provided by the regulations means that many organizations will continue to be faced with not knowing for sure if their trade or business activities are being regularly carried on.

### **WHEN IS A TRADE OF BUSINESS NOT SUBSTANTIALLY RELATED TO A TAX-EXEMPT ORGANIZATION’S TAX-EXEMPT PURPOSE?**

The third problem with applying the test to determine if a tax-exempt organization is subject to the UBIT lies with the difficulty of determining when a trade or business is substantially related to the organization’s tax-exempt purpose.

Many tax-exempt organizations readily admit (or are forced to concede) that they regularly carry on a trade or business. They hope to avoid the UBIT, however, by claiming that the trade or business is substantially related to their tax-exempt purpose.

Determining whether the trade or business of a tax-exempt organization is substantially related to the organization’s tax-exempt purpose requires a detailed examination and analysis of the organization’s tax-exempt purpose, the activities that generated the income and how those activities contribute to the organization’s ability to accomplish its tax-exempt purpose. In order for a trade or business to be treated as substantially related, the conduct of the trade or business must have a causal relationship to the achievement of that purpose and that causal relationship must be substantial. Therefore, the production or

distribution of the goods or the performance of the services by the organization must contribute “importantly” to the accomplishment of the tax-exempt purpose. Whether activities contribute importantly depends in each case on the surrounding facts and circumstances, taking into account the size and extent of the activities involved in relation to the nature and extent of the exempt function that they purport to serve. A trade or business will not be treated as substantially related to an organization’s tax-exempt purpose just because all earned income will be used to support the organization’s tax-exempt activities.

As should be evident from the rules outlined above, determining whether the trade or business of a tax-exempt organization is substantially related to the organization’s tax-exempt purpose is not a simple, straightforward exercise. After applying the rules to a specific situation, a tax-exempt organization may still be unable to answer with certainty if asked whether its trade or business is substantially related to its tax-exempt purpose.

### **CONCLUSION**

While many tax-exempt organizations will have no problem concluding that they are subject to the UBIT, that will not always be the case. Some tax-exempt organizations, when asked if they are subject to the UBIT, may have to just throw up their hands and exclaim “Who the heck knows?”

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For more information, contact members of the [Nonprofit & Tax-Exempt Organizations](#) group.

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