UBIT Exceptions Let Non-Profits Run Tax-Free Businesses

By taking advantage of seven exceptions to the unrelated business income tax (UBIT) rules, non-profits can reduce or avoid their UBIT exposure.

by JAMES R. HASSELBACK and ANGELA Y. ROBBINS

The unrelated business income tax (UBIT) was created by the Revenue Act of 1950 specifically to address many taxable organizations' concerns about unfair competition. Nonexempt organizations claimed that an exempt organization's status allowed it to expand and operate competitive businesses with lower operating costs due to the absence of tax. For UBIT purposes, unrelated business income (UBI) consists of three elements. These elements attempt to encompass truly competitive trades or businesses run by exempt organizations, while excluding activities of tax-exempt organizations that do not pose a threat of unfair competition. The UBIT rules also provide seven exceptions to the definition of unrelated business income, providing tax planning opportunities for exempt organizations.

UBIT is codified in Sections 511 through 515. UBI is defined generally in Section 512(a)(1) as the "income derived by any organization from any unrelated trade or business, regularly carried on by it." This general definition describes the three elements that must be present for UBI to exist: (1) an unrelated, (2) trade or business, (3) that is regularly carried on.[1]

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Unrelated

Section 513(a) provides that an organization's activities are unrelated if they are "not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption...." Not only must the relationship between the activity and the accomplishment of the organization's exempt purposes be causal, it must be a substantial causal relationship in which the activity contributes importantly to the accomplishments of the exempt purpose.[2]

To determine if an activity contributes importantly, Reg. 1.513-1(d)(3) states that "the size and extent of the activities involved must be

considered in relation to the nature and extent of the exempt function which they purport to serve." Thus, if an organization carries on an activity that is related to its exempt functions, but on a larger scale than is reasonably necessary for performance of the exempt functions, the income above what is reasonably necessary is included in UBI.

Although the UBI rules require a facts and circumstances approach, some broad standards can be derived from IRS Rulings.

Three elements must be present for UBI to exist: (1) an unrelated, (2) trade or business, (3) that is regularly carried on.

Sales of goods and services. *Rev. Rul.* 81-61[3] discussed a senior citizen's center that operated a beauty and barber shop in its building. The Service ruled that the income derived from the shops was not UBI because "providing senior citizens, many of whom have physical impairments resulting in a limited ability to travel, with the services of beauticians and barbers in a place convenient for them to reach is an activity that contributes importantly to the achievement of the organization's exempt charitable purpose."

In contrast, the Service ruled in *Rev. Rul.* 81-62[4] that the sale of major appliances in a senior citizen's center did produce UBI. Because the sale of the appliances did not contribute to the physical, health, recreational, social, or intellectual needs of the elderly, such sales were not substantially related to the exempt purpose of the organization. Furthermore, the Service pointed out that major appliances are not purchased often and do not necessarily need to be purchased in person, unlike personal grooming services.

The substantially related test also is applied to the sale of goods in a retail operation. In *Rev. Rul.* 73-127,[5] the Service determined that the sale of groceries in a retail store did result in UBI; three years later, however, in *Rev. Rul.* 76-94,[6] the IRS allowed income from the sale of groceries in a retail store to be excluded from UBI. Although both fact patterns had similarities, the size and extent of the operation relative to the organization's exempt purpose became the deciding factor.

In the first ruling, the store employed many people who were not in a hard-core unemployed training program, and who had experience in the retail food industry. The Service, although recognizing the need for a retail business as a "campus" for the trainees, held that the size and manner of the store's operation was in excess of what was reasonably necessary to accomplish the exempt purpose of the organization. Therefore, it said that the income should be characterized as unrelated business income.

In comparison, the retail store of the later ruling employed only persons who were participating in the organization's rehabilitation program, with the exception of the manager who was "experienced in both the retail food industry and in working with disturbed adolescents." Again looking to the size of the activity in relationship to the organization's exempt purpose, the Service found that the retail operation was "operated on a scale no larger than is reasonably necessary for the organization's training and rehabilitation program;" therefore, "the grocery store contributes importantly to the organization's charitable program and is not [an] unrelated trade or business."

Gift shops. The classification of income derived from the operation of a gift shop depends on the nature of the items being sold. In *Rev. Rul.* 73-104,[7] the Service determined that the income from an art museum gift shop was not UBI since the gift shop sold items related to its own works or art in general. The Service held that the sale of items related to art (such as art books and greeting cards with reproductions of art on them) contributed importantly to the museum's exempt purpose of art education, and

1 Reg. 1.513-1(a).
2 Reg. 1.513-1(d)(2).
3 1981-1 CB 355.
4 1981-1 CB 355.
5 1973-1 CB 221.
6 1976-1 CB 171.
7 1973-1 CB 263.

therefore the gift shop was a substantially related trade or business not subject to UBIT.

In contrast, the Service concluded in *Rev. Rul.* 73-105[8] that the income from an art museum's gift shop was indeed UBI because the income was derived from the sale of scientific books and city souvenirs. The Service reasoned that these products did not contribute importantly to the exempt purpose of art education. Therefore, the gift shop activity was not substantially related to the exempt purpose of the museum. Under the fragmentation rule (discussed below), if a gift shop sells some substantially related items and some unrelated items, its income will be apportioned between UBI and income not subject to the tax.

Trade or business

Income from an unrelated activity of an exempt organization is UBI only if the activity is a trade or business under Section 162.[9] This reference to Section 162 does not provide much help to a taxpayer, however, because trade or business is left undefined there. Reg. 1.513-1(b) does state that the definition of a trade or business generally includes "any activity carried on for the production of income from the sale of goods or performance of services." Furthermore, the Regulations seem to emphasize the concept of unfair competition by stating, "[t]he primary objective of ... [UBIT] was 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." So it seems as if the presence of actual or potential commercial competition would be the primary measure of whether an activity was a trade or business.

The courts, however, have taken a different approach to determining whether an activity is a trade or business. There are several aspects of an activity that the courts have traditionally looked to in deciding the trade or business issue: profit motive, presence or absence of competition, and how the activity is conducted.

Profit motive. The presence of a profit motive has become the primary determination for UBIT purposes, with the presence of competition and how the activity is conducted supporting or countering that judgment. The supremacy of profit motive as the determinant of a trade or business was established in *American Bar Endowment.*[10] American Bar Endowment is a charitable corporation whose members are members of the American Bar Association. Endowment raises money for its charitable causes by providing experience-rated group insurance policies to its members. Endowment requires its members to assign to it any excess dividends from the insurance policy.

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Since the experience of the Endowment participants has been very good, the excess premium dividends have always been substantial. The Service contended that this provision of insurance was an unrelated trade or business; the Endowment argued that it was conducting fundraising activities, with the excess dividends it kept being charitable contributions from its members. The Supreme Court decided in favor of the IRS. In a footnote, the Court stated "the standard test for the existence of a trade or business for purposes of §162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.'"[11] Because the Supreme Court found the existence of a profit motive, it had to conclude that the provision of group insurance to the Endowment's members was a trade or business.

Another case that applied the profit-motive test in determining whether an activity was a trade or business involved a postal workers' union that provided health insurance for its members and some nonmembers.[12] The charges

8 1973-1 CB 264.
9 Reg. 1.513-1(b).
10 477 U.S. 105, 58 AFTR2d 86-5190, 86-1 USTC ¶9482 (S.Ct., 1986).
11 *Id.*, citing Brannen, 722 F.2d 695, 53 AFTR2d 84-579, 84-1 USTC ¶9144 (CA-11, 1984).
12 American Postal Workers Union, 925 F.2d 480, 67 AFTR2d 91-571, 91-1 USTC ¶50,096 (CA-D.C., 1991).

for nonmembers to enroll, including $35 for "dues," provided the union with an over 80% profit margin, and the only benefit the nonmembers were entitled to for their dues was health insurance. The appellate court thus decided that a profit motive existed, stating that "there is no better objective measure of an organization's motive for conducting an activity than the ends it achieves."[13] With the existence of a profit motive established, the court had no choice but to deem the activity a trade or business within the meaning of Sections 513 and 162.

Competition. Although courts use the presence of a profit motive as the primary factor when determining whether an activity is a trade or business for UBIT purposes, they also look at other factors. One of these other factors appears to be the presence or absence of real or potential commercial competition.

Courts use the presence of a profit motive as the primary factor when determining whether an activity is a trade or business.

For instance, *Greene County Medical Society Foundation*[14] illustrates an application of the "competition criteria." The Foundation was a tax-exempt medical association that produced and sold "novelty or souvenir type" phonographic records by "The Singing Doctors." The court found that the production and sale of these records were not "competitive with the 'ordinary business' of commercial record production and sales." The court thus ruled that the Foundation's sale of phonographic records was not a trade or business for UBI purposes. The presence or absence of a profit motive was not considered in this case at all. Rather, the court's opinion was based on a finding that the record sales were not in competition with any other taxable entity.

How activity is conducted. Another factor that courts look to in deciding whether an activity is a trade or business is the manner in which the activity is conducted. An application of this factor can be seen in *Disabled American Veterans.*[15] The Disabled American Veterans (DAV) possessed a very extensive mailing list, which it copiously updated and maintained. New names were added to the mailing lists from rentals of other organizations' mailing lists, and semiannually the mailing list was purged of obsolete names. In 1960, the DAV began renting out its mailing list to other fundraising organizations and commercial entities. In renting out the list, the DAV followed the trade practices of the Direct Mail Marketing Association, of which the DAV was a member. Some of these trade practices included sending rate cards to list brokers, charging higher rates for rentals to other fundraising organizations than to commercial organizations, and offering several alternative formats and groupings of its mailing list.

When deciding whether the DAV's mailing list rental activity was a trade or business, the court concluded that the necessary element of a trade or business for UBIT purposes is "that an activity be operated in a competitive, commercial manner." Since the court found that "DAV operated in a competitive manner in renting its donor list," the activity was held to be a trade or business for UBIT purposes.

Occasionally the manner in which an activity is conducted is used to support the finding of a profit motive. An example of this is *St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc.*,[16] The Brothers of St. Joseph operated a farm on which they grew corn, wheat, and soybeans, and raised beef cattle. In 1978 and 1979, the farm participated in farm price support programs administered by the U.S. Department of Agriculture. The Brothers contended that their farming activity was not a trade or business because there was no profit motive due to the vows of poverty taken by the workers, and because many of their operational practices were inconsistent with profit-maximization.

13 *Id.*, citing Carolinas Farm and Power Equipment Dealers, 699 F.2d 167, 51 AFTR2d 83-546, 83-1 USTC ¶9161 (CA-4, 1983).
14 345 F. Supp. 900, 30 AFTR2d 72-5227, 72-2 USTC ¶9604 (DC Mo., 1972).
15 650 F.2d 1178, 48 AFTR2d 81-5047, 81-1 USTC ¶9443 (Ct. Cl., 1981).
16 85 TC 9 (1985).

The Tax Court disagreed with the Brothers, stating that "the record shows that petitioner's operation ... is indistinguishable from the operation of any other for-profit farm. The scale of petitioner's operations, the marketing of the farm products and petitioner's participation in Government-sponsored farm subsidy programs are all factors militating toward the conclusion that the farm was operated for profit." Since the Tax Court inferred a profit motive from the manner in which the farm was operated, the court had to rule that the farming operation was a trade or business for UBIT purposes.

Fragmentation rule. The general concept of the "fragmentation rule" is spelled out in Reg. 1.513-1(b), which states that "[a]ctivities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as a trade or business merely because they are carried on within a larger aggregate of similar activities...." An example of the fragmentation rule is the art museum gift shops discussed above.[17] In *Rev. Rul.* 73-104, the sale of greeting cards displaying reproductions of art did not generate UBI, but under the fragmentation rule, the sale of science books by the same gift shop would generate UBI. Thus, if an activity involves the sale of more than one line of goods, or the performance of more than one service, each service or separate line of goods is an individual activity, to which a determination of trade or business has to be made.

Regularly carried on

The final element in determining if income from an organization's activities is unrelated business income is whether the activity is regularly carried on by the organization. Reg. 1.513-1(c)(1) provides that "regard must be had to the frequency and continuity with which the activities ... are conducted and the manner in which they are pursued." The Regulations also state that these factors of frequency, continuity, and manner of conduct should be compared with the nonexempt businesses with which they compete. Furthermore, Reg. 1.513-1(c)(2) identifies four time frames in which activities might occur: normal time spans, year-round time spans with the activity occurring only one day a week, intermittent activities, and intermittent activities with infrequent conduct.

The guidance for normal-time-span activities and year-round, one-day-a-week activities is relatively simple to apply. For activities that a taxable organization conducts and operates on a year-round basis, the regularly carried on element is not satisfied when the activity is operated for only a few weeks by the tax-exempt organization. On the other hand, if the activity is seasonal for taxable organizations, the operation of the activity for a few weeks by the tax-exempt organization is considered regularly carried on. Also, if the tax-exempt organization operates an activity year-round, but only on one day a week (the example given is a commercial parking lot open only on Saturdays), the activity is considered to be regularly carried on.

The frequency, continuity, and manner of conduct should be compared with nonexempt businesses with which the exempt organization competes.

The Regulations' guidance becomes somewhat harder to apply with respect to intermittent activities. Reg. 1.513-1(c)(2)(ii) states that, for intermittent activities, "the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations." In determining whether an activity is intermittent, the Regulations imply that an intermittent activity is "engaged in only discontinuously or periodically." One example given in that Regulation is advertising published in programs for sports or performing art performances.

The situation described in that example arose in *Suffolk County Patrolmen's Benevolent Association, Inc.*[18] The Patrolmen's Association held a vaudeville show one weekend a year, for six consecutive years. At the shows, the Association distributed programs that contained

17 Rev. Ruls. 73-104, *supra* note 7, and 73-105, *supra* note 8.
18 77 TC 1314 (1981).

advertising from local businesses. The advertising solicitation began eight to 16 weeks before each year's show and was conducted by the organization that put on the show. The court found this case to be very similar to the example in Reg. 1.513-1(c)(2)(ii); therefore, the court ruled that income from the show and advertising for the program were not derived from a regularly carried on activity.

The court did not consider the advertising solicitation period as part of the duration of the activity in reaching its decision. It held that this solicitation period was organization and preparation time, which was irrelevant in the "regularly carried on" determination.

The fourth category of activity time spans is the intermittent activity that is conducted infrequently. Reg. 1.513-1(c)(2)(iii) implies that "infrequently" means "only occasionally or sporadically." Furthermore, the Regulations make sure to point out that "such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis." In regard to such infrequent, intermittent activities, the Regulations state that neither the recurrence rate nor the manner of conduct is relevant to making the determination of whether the activity is regularly carried on. The activity's infrequency of operation is sufficient for the determination.

UBI exceptions

There are seven exceptions to the definition of UBI that exempt organizations may use for tax planning purposes.

Volunteer exception. The volunteer exception is defined in Section 513(a)(1) and Reg. 1.513-1(e)(1). The Regulations state that an unrelated trade or business "does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation...." *Rev. Rul.* 80-106[19] provides an illustration of this exception—a thrift shop operated by uncompensated volunteers that sold donated items and items placed on consignment. Since substantially all of the work was performed by volunteers, the IRS ruled that the income generated by the thrift shop was not subject to income tax.

Another example of the "volunteer exception" involved a volunteer fire department that charged the general public admission to weekly dances. The Ruling recognized that, "holding public dances and charging admission on a regular basis may, given the facts and circumstances of a particular case, be the conduct of unrelated trade or business within the meaning of section 513...."[20] The Ruling concluded, however, that there was no UBI because, "in this case, the work in conducting the weekly public dances was performed by unpaid volunteers."

The Service has not allowed this exception to be used across the board, however. In *Rev. Rul.* 78-144,[21] the exception did not apply because the "work" of the volunteers was not substantial. An exempt organization leased out heavy machinery that it owned. Once the machine was leased, the lessee had full responsibility for taxes, insurance, and repairs. Lease terms were renewable for five-to-eight-year periods, with most leases being renewed until machine obsolescence occurred. The work involved with the leasing operation—finding a lessee, negotiating the lease, and processing subsequent payments—was performed for the organization by volunteers. The Service held that "the only regularly occurring work in carrying on the leasing activity is the processing of the rental payments from the leases." Consequently, the IRS ruled that "although the work in carrying on the rental activity may be performed without compensation, the performance of services in this case was not a material income-producing factor in the business and, therefore, section 512(a)(1) ... does not apply."

The amount of work performed by the volunteers also determined whether the volunteer exception applied in *Waco Lodge No. 166, Benevolent & Protective Order of Elks*.[22] This case involved an Elks lodge that held regular bingo games for which approximately 23% of the work was performed by paid persons. The

19 1980-1 CB 113.
20 Rev. Rul. 74-361, 1974-2 CB 159.
21 1978-1 CB 168.
22 696 F.2d 372, 51 AFTR2d 83-629, 83-1 USTC ¶9165 (CA-5, 1983).

courts held that the percentage of compensated workers was substantial enough that the UBI exception did not apply.

Another factor that must be considered when contemplating the use of the volunteer exception is whether the workers are receiving constructive compensation. In *St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc.*,[23] the Service attempted to deny the volunteer exception for the Brothers, claiming that the "food, clothing, shelter, and medical care received by the Brothers who operate the farm should be treated as compensation within the meaning of section 513(a)(1)." The court disagreed, stating that "there must be a 'but-for' connection between the payment and the services." Since the Brothers would be provided with food, clothing, shelter, and medical care regardless of whether they worked on the farm, the court ruled that a but-for relationship did not exist. Therefore, the Brothers did not receive compensation for their services, and the volunteer exception applied. The IRS non-acquiesced to this decision.

Convenience exception. Section 513(a)(2) provides an exception to the definition of an unrelated trade or business for a business carried on for the convenience of certain groups of people. Reg. 1.513-1(e)(2) states that the definition of an unrelated trade or business does not include, "[a]ny trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees...." The example given by the Regulation is a laundry operated by a college for use by the dormitories and students. University bookstores have also made use of this exception in their sales of computers to students and faculty.

The Regulations provide another facet of this exception, applicable to local associations of employees described in Section 501(c)(4) that were organized before 5/27/67. This very limited exception applies only to trades or businesses of such organizations "which consist of the selling ... of items of work related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars...." This exception is limited further to only those items supplied at the employees' regular places of employment.

Bingo exception. The "bingo exception," is in Section 513(f). Reg. 1.513-5(a) states that "in the case of an organization subject to the tax imposed by section 511, the term 'unrelated trade or business' does not include any trade or business that consists of conducting bingo games...." Reg. 1.513-5 restricts this exception by specifically defining bingo games, and disallowing the exception in certain circumstances. The Regulations state specifically that the definition of a bingo game does not include any game of chance other than the typical bingo game described in the Regulation.

Organizations can avoid UBI on the sale of merchandise, 'substantially all of which has been received ... as gifts....'

Some characteristics of this "typical" bingo game are that "wagers are placed, winners are determined, and the prizes ... distributed in the presence of all persons placing wagers in the game" and that the game is played with cards in which participants attempt to form predetermined patterns by the random covering up of called numbers. Furthermore, the circumstances that will result in disallowance of the exception include the operation of bingo games in states where bingo is not allowed by state law, and the operation of bingo games in a jurisdiction where there is for-profit, commercial competition.

Convention and trade show exception. Section 513(d)(3)(C) provides for an exception to the definition of an unrelated trade or business for conventions and trade shows by an exempt organization that "regularly conducts as one of its substantial exempt purposes a show which stimulates interest in, and demand for, the

23 85 TC 9 (1985).
24 TAM 8507001.

products of a particular industry or segment of such industry...."

Public entertainment exception. The "public entertainment" exception applies only to agricultural and educational fairs and expositions. Section 513(d)(2) defines public entertainment to mean "any entertainment or recreational activity of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes...."

Contributed property exception. Reg. 1.513-1(e)(3) allows organizations to forgo the recognition of UBI from the sale of merchandise, "substantially all of which has been received by the organization as gifts or contributions." The example given in the Regulation is a thrift shop operated by a tax-exempt organization that raises money by selling contributed old clothes, books, and furniture to the general public. The Service seems to be willing to expand this exception to include an organization that sells donated goods to third-party nonexempt thrift stores, instead of through stores they operate themselves.[24]

Low-cost item exception. An exception for low-cost items was first provided in Reg. 1.513-1(b) by the statement, "where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply...." TRA '86, however, amended Section 513(h), clarifying and limiting the exception's use. Section 513(h)(2)(A) defines a low-cost item as one that costs the exempt organization no more than $6.70 in 1996 (adjusted annually for inflation).

Furthermore, Section 513(h)(3) requires that the distribution be made without the express consent or request of the distributee, and be accompanied by a request for a contribution along with a statement that the article may be kept without regard to whether a contribution follows. From the above rules, it is evident that TRA '86 was attempting to limit the use and abuse of the "low cost article exception."

Conclusion

UBIT was enacted to address the concerns of unfair competition made by many taxable entities. Through the three elements that make up the definition of UBI, the Code attempts to "level the playing field" when unfair competition is noted, without putting an undue tax burden on organizations that rely mainly on contributions as a livelihood. Income from an exempt organization's activities is UBI only if it meets the three-element test. The income *must* be from an *unrelated, trade or business* that is *regularly carried on* by the organization. This three-pronged definition, along with its seven exceptions, provides ample opportunity for an exempt organization to plan its activities to escape UBIT treatment. ◆