

Unrelated Business Income

Preston C. Worley & John-Paul Volk

(MCBRAYER)



What is Unrelated Business Income Tax (UBIT)?

[UBIT: Unrelated Business Income Tax]

Unrelated Business Income Tax (UBIT) in the U.S. Internal Revenue Code (“IRC”) is:

- The tax on unrelated business income
- Which comes from an activity engaged in by a tax-exempt 26 USCA 501 organization
- That is not related to the tax-exempt purpose of that organization.



[Nonprofit]



- A nonprofit corporation has been organized to meet specific tax-exempt purposes.
- To qualify for nonprofit status, the corporation must be formed to benefit the following:
 - (1) the public
 - (2) a specific group of individuals
 - (3) the membership of the nonprofit.

Examples: Religious organizations, charitable organizations, political organizations, credit unions and membership clubs such as the Elks Club or a country club.

- Nonprofit corporations enjoy the same liability protection as regular corporations and LLCs. In other words, your directors, trustees, members, and employees are not generally responsible for corporate debts and liabilities.

[501(c)(3)]

- A 501(c)(3) organization is a nonprofit organization that has registered with the Internal Revenue Service, thereby allowing the entity to become a federally **tax-exempt** charity that does not pay income or sales tax.
- The 501(c)(3) designation also allows donors to **write off** contributions. Many for-profit organizations, and some nonprofit organizations, set up related 501(c)(3) organizations to do charitable work.

UBIT: Unrelated Business Income Tax



- Unrelated Business Income Tax (UBIT) in the U.S. IRC is the tax on unrelated business income, which comes from an activity engaged in by a tax-exempt 26 USCA 501 organization that is not related to the tax-exempt purpose of that organization.
- This addresses when a nonprofit 501(c)(3) organization expands into areas outside of the tax-exempt purpose.

UBIT: The Nonprofit Concern

The IRS allows a tax-exempt nonprofit to conduct income-generating business activities that are unrelated to its exempt purpose, as long as those activities are “reasonably commensurate” with its resources.

Examples of unrelated business activities:

- An organization whose exempt purpose is to promote public interest in fine art leases apartments to artists and runs a dining hall for these tenants.
- A humane society organized for the purpose of the prevention of cruelty to animals operates pet boarding and grooming services.

[UBIT: The Alternative]

A nonprofit, however, may lose its tax-exempt status if its unrelated business activities begin to overshadow the activities it conducts in furtherance of its exempt purpose. In these instances, it is worth considering transferring unrelated business activities to a separate for-profit subsidiary to protect the organization's tax-exempt status.

The IRS is all over the place with this:

- A 501(c)(3) lost its status after generating between 29 and 35 percent of its revenue from unrelated business activities in three consecutive years.
- Another organization to keep its tax exempt status even though 39% of gross receipts came from unrelated business.

[Question]



What can you do to avoid losing your tax-exemption over unrelated business income activities?

For-Profit Subsidiaries

Alternatives: Setting up a For-Profit



- What type of entity should a nonprofit set up as a for-profit subsidiary?
- What factors should be considered?

[For-Profit Option 1: Corporate Tax Form]

- The corporate form provides the most protection to a nonprofit's tax-exempt status protection when used for the subsidiary.
 - Separates the parent from the subsidiary because it requires directors and officers to follow more formalities and procedures compared to other entity forms.
 - As long as separation is maintained, the corporate form may prevent a subsidiary's for-profit activities from being attributed to its parent nonprofit.

[For-Profit Option 2: LLC]

- A for-profit subsidiary can also be formed as a limited liability company (LLC). This is not recommended because:
 - The IRS will attribute the subsidiary's business activities to the parent nonprofit in its determination of whether the nonprofit operates solely for exempt purposes.
 - The parent nonprofit will be subject to unrelated business income tax if the business activities are unrelated to the nonprofit's charitable purpose, since the LLC is a pass-through entity where profits are taxed directly to the nonprofit.

Ultimately, any tax-exempt status protection that the nonprofit intended to gain by forming a subsidiary in the first place would be greatly reduced because of attribution of unrelated business activity to the nonprofit.

Attribution

- In a ruling published in 1986, a scientific research organization and its subsidiary were examined. The subsidiary worked to develop and manufacture products that were derived from technology generated out of the parent's research activities.
- The activities of the subsidiary were **attributed** to the parent because the parent maintained a controlling interest in the subsidiary, there were overlapping employees between the two entities, and there was sharing of facilities and equipment.

Attribution

- Subsidiary must establish itself as a separate legal and tax entity from the parent.
- The IRS scrutinizes parent-subsubsidiary relationships that appear to lack bona fide intent to have real and substantial business functions.



Attribution

- More recently, the IRS has moved away from taking such aggressive stances. As long as there is no “clear and convincing” evidence that shows the subsidiary is acting as an agent or integral part of the tax-exempt parent, the IRS has ruled that the subsidiaries activities will not be attributed to the parent.
- However, in situations where the parent controls the affairs of the subsidiary so closely, like when the parent is directly involved in the day-to-day management of the subsidiary, the subsidiary may not be regarded as a separate entity and therefore be disregarded for tax purposes.

Attribution

- There is no one factor that determines whether attribution should occur, but rather, the IRS examines the facts and circumstances and weighs multiple factors in making this determination. These include:
 - The officers, trustees or employees of the tax-exempt parent constitute a majority of the for-profit subsidiary's board of directors. This level of control demonstrates that the subsidiary is acting as an agent or integral part of the parent.
 - The boards between the two organizations are identical.
 - The activities between the parent and subsidiary are conducted at arm's length.
 - The parent is involved in the day-to-day management of the subsidiary.

Factors Considered by the IRS

[Factors Considered by the IRS]

- The most common reason to create a for-profit subsidiary is to separate an unrelated business activity from the parent to protect it from violating the “primary purpose test”, and to a lesser extent, the “commensurate test.”



The Primary Purpose Test

- The Primary Purpose Test looks at the actual activities of the organization and requires that it not be organized or operated for the primary purpose of carrying on an unrelated trade or business.
- It must be primarily engaged in fulfilling of its exempt mission.
 - What exactly constitutes 'primary' is determinant by facts and circumstances which will include the size and extent of the unrelated business activity.
- Ultimately no more than an insubstantial amount of activities can be devoted to an unrelated trade or business.
 - Insubstantial is not defined by a fixed percentage - this uncertainty may be a motivating factor for some exempt organization managers and boards to gravitate towards the for-profit subsidiary solution.

The Commensurate Test: The Law

- Section 1.501(c)(3)-1(c)(1) of the Treasury Regulations provides that an organization will not qualify for tax exemption if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.
- However, section 1.501(c)(3)-1(e) of the Treasury Regulations provides that an organization may qualify for tax exemption even if it operates a trade or business as a substantial part of its activities if such operation is in furtherance of its exempt purpose and it is not organized and operated for the “primary purpose” of carrying on a trade or business.

[Commensurate Test]

- Under the commensurate test, an organization would not lose its exemption for engaging in substantial commercial activity as long as the organization's charitable programs are **commensurate in scope** to its income and financial resources.

The idea is that donors fund charities to do charitable works, not to amass a fortune with no clear plan of how the funds will be spent.

[Commensurate Test]

- Unfortunately, neither the Code nor the Treasury Regulations state what it means to be commensurate in scope.
- Some courts and IRS agents apply a “commerciality test” to determine:
 - (1) what constitutes unrelated business generating taxable income
 - (2) when certain commercial activity will preclude tax exemption under IRC section 501(c)(3).
- The “commerciality test” disqualifies from exemption an organization that is operating in a commercial manner, for example, by engaging in activities **that compete with** for-profit entities.

Advantages of Utilizing a For-Profit Subsidiary

Advantages of Utilizing a For-Profit Subsidiary

1. Expanding Activities Beyond Those That Are Clearly Charitable/Tax-Exempt

- Tax-exempt status of the organization is threatened by scrutiny of unrelated business activity
- No bright line for how much unrelated business activity is too much
- It isn't always clear when an activity might be unrelated
- Housing the activity in a subsidiary avoids these concerns

Advantages of Utilizing a For-Profit Subsidiary

2. Shielding the Parent from Liability

- Nonprofit may not want to risk assets by operating business with potential liabilities
 - Especially true for those with large endowments or other significant assets
- Isolating the business in a limited-liability subsidiary protects the parent

Advantages of Utilizing a For-Profit Subsidiary

3. Attracting Outside Investors

- For-profit entities can offer equity to investors to raise money
- Non-profits must rely on contributions, etc., but cannot offer equity
- For-profit vehicle expands access to capital



Advantages of Utilizing a For-Profit Subsidiary

4. Spinning Off the Business

- If the nonprofit wants to sell the business, it's easier if the activity is segregated in a subsidiary
 - Business can be valued separately from the parent
- Parent's equity interest can be transferred, avoiding the process of identifying and assigning individual assets and liabilities

Advantages of Utilizing a For-Profit Subsidiary

5. Attracting and Compensating Employees

- For-profits can offer equity compensation and other profit-sharing opportunities that a nonprofit can't
- This flexibility may be important for attracting talent.

Disadvantages of Utilizing a For-Profit Subsidiary

Disadvantages of Utilizing a For-Profit Subsidiary

1. Administrative Cost & Efficiency

- Two entities are more complicated and costly to operate than one
- Corporate formalities must be preserved to protect separation of the entities
 - Separate governing body
 - Separate board and committee meetings
- Assets must be kept separate
- Agreements must be made for shared resources
- All transactions must be done at fair market value

Disadvantages of Utilizing a For-Profit Subsidiary

2. Prudent Investor Considerations

- If the subsidiary's activities are not related to the parent's charitable purposes, investment in the new entity should be a reasonable use of the organization's resources and may need to satisfy a "prudent investment" standard
- Nonprofit parent must capitalize the subsidiary
- A contribution in return for an equity interest is an investment



Disadvantages of Utilizing a For-Profit Subsidiary

2. Prudent Investor Considerations, cont'd

- The parent must determine whether the investment is either
 - (1) a prudent investment that will not violate any state fiduciary requirements or prudent investor laws, or
 - (2) a “program-related” investment that is being made primarily to further a charitable purpose rather than an investment purpose.
- If a subsidiary is formed to house business activities that are unrelated to the parent’s tax-exempt purpose, only the first option may be available
- Nonprofit must be aware of prudent investment standards (i.e., the Uniform Prudent Management of Institutional Funds Act, etc.)

Disadvantages of Utilizing a For-Profit Subsidiary

2. Prudent Investor Considerations, cont'd

- Private foundations face additional restrictions:
 - Generally may not own more than 20 percent of a business entity such as corporation or an LLC, unless the corporation or LLC is operating a business that is functionally related to the foundation's mission.
 - A private foundation also can be taxed on investments that jeopardize its tax-exempt purposes.
 - A “program-related investment” – one that is made primarily to accomplish a charitable purpose and with no significant investment purpose (see Internal Revenue Code Section 4944) – is not subject to either of these restrictions.

Disadvantages of Utilizing a For-Profit Subsidiary

3. Compliance with Securities Laws

- Depending on the number, residence, and sophistication of any other investors involved other than the nonprofit organization, securities laws may apply
 - This can involve compliance costs and delays.
 - If participation is limited to the nonprofit, or to a small number of outside investors in addition to the nonprofit, securities-law compliance costs may not be significant.



Conclusion

McBRAYER

Conclusion

- Use of a for-profit subsidiary can be an effective strategy for a variety of reasons, from shielding a nonprofit organization from liability or the tax consequences of conducting an unrelated business activity, to attracting outside investment and scaling a business beyond what might be possible if conducted inside the nonprofit parent.
- When a revenue-generating activity or a significant asset is involved, the directors of a nonprofit organization and legal counsel should consider whether a subsidiary would make sense.

Any questions?

Preston C. Worley

pworley@mmlk.com

John-Paul Volk

jvolk@mmlk.com

859-231-8780

mmlk.com



[MCBRAYER]