UBIT Woes: Creating and Maintaining a
Taxable Subsidiary

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I. What is the Unrelated Business Income Tax (UBIT) and why should I be concerned about it?

A. What is unrelated business income?

While exempt organizations are generally not taxed on their income, this does not apply to income earned from activities unrelated to a tax-exempt organization's purposes. Such income is taxed as if earned by a comparable for-profit entity and is subject to tax at the regular corporate rates. In computing unrelated business income taxes, most recognized business deductions are available to exempt organizations.

B. Why is such income taxed?

Prior to 1950, non-profits could own and operate unrelated businesses without being taxed on the profits from those business. The inequities became evident in the case of C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (1951). Because of a donation of stock to the New York University School of Law, this non-profit found itself running and deriving tax-free revenues from the Mueller Macaroni Company.

The unrelated business income tax was enacted, and revised in the Tax Reform Act of 1969, to level the playing field between exempt and taxable organizations. Code § 513(a). The laws tax applies to virtually all tax-exempt organizations, including IRC § 501(c)(3) organizations (private foundations and public charities) as well as religious, social welfare, business, labor, and fraternal organizations.

C. Are there other difficulties with unrelated business income, aside from the need to pay taxes?

If unrelated business income comprises a "substantial" portion of an exempt organization's income, the result can be loss of tax-exempt status. Indiana Retail Hardware Association v. U.S., 366 F.2d 998 (Ct. Cls. 1966). As for what constitutes a substantial potion, no mechanical test is available. In the context of what represents substantial legislative activities of exempt organization, the IRS has defined substantial to be 5% or greater. Reg. 1.501(c)(3)1(b)(3)(i). Yet, the IRS did not revoke an organization's tax exemption even though 75% of its income was derived from unrelated sources. Rev. Rul. 57-313, 1957-1 C.B. 316.

One rule of thumb often followed by practitioners is 20%. Thus whenever an organization's unrelated business income exceeds 20% of gross income, the legal risks and options available to the organization should be carefully evaluated and monitored. If an

organization's unrelated business income exceeds 50%, it will almost certainly wish to consider creating a for-profit subsidiary to avoid the likelihood that an IRS audit would find that the organization's activities do not primarily further exempt purposes.

D. How is unrelated business income defined?

The IRS applies a three-prong test. Unrelated business income is considered to be income derived from 1) a trade or business, 2) which is regularly carried on, and 3) which is not substantially related to the performance of tax-exempt functions, i.e., it does not contribute importantly to the achievement of tax-exempt purposes. The fact that income was produced for use in furthering exempt purposes does not qualify the income as related; the income itself must be derived in the course of furthering an exempt purpose. IRC § 513(a). For unrelated business income taxes to be incurred, all three elements must be present.

1. What is meant by a trade or business?

The Code defines trade or business quite broadly as any activity carried on for the production of income from the sale of goods or the performance of services. Regs. § 1.513-1(b). Fundraising is not itself considered a trade or business.

Also excluded is revenue generated passively. Passive income generally includes interest earnings, dividends, royalty payments, rents from real property, and revenues from the sale of property. IRC § 512(b)(1)-(3). Payments denominated royalties that are in fact fees for services will be taxable. Thus, royalties did not include payments for personal appearances (Rev. Rul. 81-178, 1981-2 C.B. 135) or receipts from the rental of donor lists (Disabled American Veterans v. United States, 650 F.2d 1178 (Ct. Cl. 1981)). Similarly, payments derived from a license of property under which an exempt organization was liable for some development and operational costs were treated as unrelated income. (Rev. Rul. 69-179, 1969-1 C.B. 158).

The Code excludes from the passive income exception income derived from controlled subsidiaries (other than dividend payments) or from the use of borrowed money if the activity is unrelated to the organization's exempt purposes. As for the latter exclusion, consider the borrowing by an exempt performing arts center borrows of funds to purchase and renovate a theater. No tax would be incurred on income generated from theater operations. If the exempt organization also purchased office space adjoining the theater and leased the space to commercial tenants, the leased portion of the property would be treated as unrelated debt-financed property and the income subject to tax. Educational institutions, employee benefit trusts, and certain title-holding organizations, deemed by the Code to be qualifying organizations, are exempt from the debt-financed property rules. IRC § 514(c)(9). Similarly, research activities otherwise excluded from unrelated business income are excluded even if funded with debt. IRC § 514(b)(1)(c), referencing IRC § 512(b)(7) - (9).

The Code deems certain other activities not to be a trade or business subject to

UBIT. These include activities if "substantially all the work in carrying on such trade or business is performed for the organization without compensation". IRC § 513(a)(1). Such an activity could include a second-hand clothing store operated by an orphanage in which substantially all of the work in running the store is performed by volunteers. S. Rep. No. 2375, 81st Cong., 2d Sess. (1950) at 108. The U.S. Tax Court case has also held that a religious order's farming income is not taxable where the farm is maintained by unpaid members of the order. St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner, 85 T.C. 9 (1985). As for when an activity is performed "substantially" by volunteers, the revenues from an art museum operated by two full-time employees and 15 volunteers have been deemed to taxable. Private Letter Ruling 8040014. By contrast, income from a similar activity conducted 95% by volunteers was ruled not to be taxable. Private Letter Ruling 8040014.

A so-called "thrift-shop" exception excludes from taxation the proceeds of the "selling of merchandise, substantially all of which has been received by the organization as gifts or contributions." IRC § 513(a)(3); Rev. Rul. 71-581, 1971-2 C.B. 165. Also excluded from consideration as a trade or business subject to UBIT is an activity carried on by an exempt organization "primarily for the convenience of its members, students, patients, officers or employees. IRC § 513(a)(2). This would include the operation by an art museum cafeteria and snack bar for use by its staff and visiting members of the public (Rev. Rul. 74-399, 1974-2 C.B. 172) the operation of gift shop (Rev. Rul. 69-267, 1969-1 C.B. 160) and parking lot (Rev. Rul. 69-269, 1969-1 C.B. 160) for the staff, patients, and visitors of a hospital, and the operation of a laundry by a college for its students (S. Rep. No. 2375, 81st Cong., 2d Sess. (1950) at 108).

In addition, under provisions of the Tax Reform Act of 1976, the term unrelated trade or business does not include certain convention and trade show activities. IRC § 513(d)(1). The income that is excluded from taxation is that derived by exempt organizations from the rental of display space to exhibitors, if the promotion of the products and services, or the education of those in attendance, advances the exempt purposes of the organization. IRC § 513 (d)(3)(B).

Other exemptions apply to most forms of bingo games (IRC § 513(f)(2)(A)), games of chance which, under state law, can only be conducted by nonprofit organizations, the sale or exchange by 501(c)(3) organizations to other 501(c)(3) organizations of their membership or mailing lists, the sale of low cost articles (costing the exempt organization (not the recipient) no more than $5, based on 1987 dollars and adjusted for inflation annually), such as T-shirts and coffee mugs, by 501(c)(3) organizations only, if their distribution is "incidental to the solicitation of charitable contributions" and if the recipient is able to retain the item regardless of whether a contribution is made. All activities to the extent of the first $1,000 of net unrelated business income are also excluded. (IRC § 512(b)(12)).

2. When is a business regularly carried on?

The regulations define a business as being regularly carried on "if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations". Reg. § 1.513-1(c)(1). Excluded are isolated sales. Thus the one-time sale of billing programs developed by an exempt health care provider is not an activity regularly carried on. IRS Private Letter Ruling 7905129.

Special events and benefits also should not qualify as not meeting the requirement of regularity. An occasional dance, to which the public is invited for a fee, would not normally constitute the regular carrying of a trade or business. Reg. § 1.513-1(c)(2)(iii). Similarly, a hospital auxiliary's operation of a food stand for two weeks at a state fair is not considered regularly carried on (IRS Publication 598); nor is the publication of advertising in the program of a cultural performance or sport event (Reg. § 1.513-1(c)(2)(ii)). This is true even if these events recur annually.

Activities conducted intermittently or sporadically throughout the year could however be treated as regularly carried on if comparable commercial activities of taxable organizations are also conducted intermittently or sporadically. Thus, the distribution of Christmas cards by an exempt organization was treated as an unrelated business, even though conducted just once per year, because comparable commercial Christmas card sellers also sell cards only one time per year. IRS Private Letter Ruling 8203134. An intermittent event may also be deemed to be an activity regularly carried on if the preparation for the event takes place over a longer period . Hence, the annual publication of a yearbook may be considered a regular activity where the solicitation of advertising sales was undertaken on a year round basis. Rev. Rul. 73-424, 1973-2 C.B. 190.

3. When is income substantially related to the organization's purposes?

As a general proposition income derived by an exempt organization is not taxed if the income-generating activity contributes importantly to the tax exempt purposes of the organization. IRC § 513(a); Rev. Rul. 75-472, 1975-2 C.B. 208. Thus, a public charity can operate a health club without incurring unrelated business income taxes where the club widely served individuals within a community (IRS Technical Advice Memorandum 8505002) but not where high membership fees discouraged widespread community membership. Rev. Rul. 79-360, 1979-2 C.B. 236. As for merchandise sales, the sales of stationery, clothing, and accessories by an environmental organization were related activities because the merchandise, in featuring the organization's logo or other conservation reference, promoted interest in wildlife preservation. IRS Private Letter Ruling 8107006.

Other activities found to be related include a bar association's sponsorship of a lawyer referral service (IRS Private Letter Ruling 8417003), a social welfare organization's provision of group insurance for member agencies (IRS Private Letter Ruling 8442092), and the sale of certain educational products and software (IRS Private Letter Rulings 8518090 and 8512084).

Activities found not to contribute importantly to exempt purposes include the provision of veterinary services for a fee by an animal cruelty prevention society (IRS Private Letter Ruling 8303001), the sale of uniforms by a labor union (IRS Technical Advice Memorandum 8437014), the provision of language translation services by an international trade promotion association (Rev. Rul. 81-75, 1981-1 C.B. 356), the management of health plans by a business league (Rev. Rul. 66-151, 1966-1 C.B. 152), and liquor sales by a veterans organization (IRS Private Letter Ruling 8530043).

The difficulty of determining whether an activity is related is further illustrated by the examples of travel tours, hospital diagnostic procedures, sales by bar associations of legal forms, sales of merchandise by museum or university shops, and journal advertising.

II. How can the use of a subsidiary help address an organization's unrelated income and other problems?

A. How can the use of a subsidiary protect an organization's exempt status?

As previously discussed, if unrelated business income comprises a "substantial" portion of an exempt organization's income, the organization risks losing tax-exempt status. The subsidiary may freely engage in commercial activity without fear of loss of exemption to the parent. To avoid abuse, Code specifically includes rents, interest, and most other forms of passive income derived from a controlled taxable subsidiary as taxable unrelated income. IRC § 512(b)(13). Dividends continue to be excluded from taxation because the subsidiary normally pays taxes on earnings before distributing dividends to the exempt parent.

B. Can the use of a taxable subsidiary provide other benefits?

Where the activity of an organization may generate exempt royalty income and taxable service income, the IRS may well treat all of the income as taxable. (Rev. Rul. 69-179, 1969-1 C.B. 158) In such a case, a taxable subsidiary may be helpful in assuming the work that generates the taxable income, while the other work can be left to the exempt organization. This is particularly valuable where an organization lends its name to third-party products and services and may have some additional management or administrative responsibility. If the licensing of the name is done by the exempt organization, the royalty income will be tax free. The management or administrative work can be done under contract between the licensee and the taxable subsidiary.

It may also be beneficial to transfer to a taxable subsidiary certain activities where the exempt organization will be limited in the deductions for the expenses associated with those activities and a taxable subsidiary will not. This is particularly the case with respect to publishing activities. Due to a rather complicated formula applied by the IRS in determining the expenses allocable by an exempt organization to advertising revenue, a publication may show a profit in the hands of an exempt organization. If all of the publishing is turned over to a for

profit subsidiary, it could well develop that the deduction of all publishing expenses from all publishing income will result in no taxable profit.

Finally, exempt organization activities may carry with them potential legal liabilities from unpaid debts, copyright or trademark infringement, defamation, or other claims. Having these activities conducted by a taxable subsidiary should shield the exempt organization from these risks to its core program mission.

III. What rules must be followed to establish the subsidiary and to make certain that the subsidiary is deemed an entity separate from the exempt organization?

A. How do we establish such a subsidiary?

The subsidiary will be created under state law in a manner similar to the creation of the exempt organization, except that the articles of incorporation and bylaws will be those appropriate for a stock corporation rather than a non-profit corporation. The initial costs of capitalization can be paid by the exempt organization through a transfer of cash or assets in return for the subsidiary's stock. Payments of the profits from the subsidiary will be made to the exempt organization as a tax-free dividend.

B. How should be subsidiary be operated so as to assure that it is treated as a separate entity?

The risk is that the exempt organization will be deemed to so control the affair of the subsidiary that the subsidiary is considered a "mere instrumentality" of the exempt organization and its independence is disregarded. No one factor will be considered in evaluating the extent of the impermissible control exercised by the parent exempt organization. Courts and the IRS will look to a range of factors, including the validity of the subsidiary's business purpose, the degree of independence of the subsidiary's management, the extent to which the subsidiary shares the parent's directors, officers, and employees, and the extent to which the two entities share facilities and services. Of these factors, the most important is the extent of independence of the subsidiary in governing its own day-to-day affairs. Generally, this means that the parent can appoint most or even all of the directors of the subsidiary and there can be a sharing of facilities and staff under an arms length reimbursement arrangement, as long as the person or people responsible for managing the day-to-day activities of the subsidiary are different and the two organizations deal with one another as distinct entities.

IV. Are there other kinds of affiliated entities an exempt organization might want to establish? A trade association ((c)(6)) or social welfare organization ((c)(4)) might consider separating its educational and research activities into a public charity ((c)(3)) that can receive tax-deductible contributions. A public charity might consider establishing a related trade association or social welfare organization to engage in "substantial" lobbying activities. See example of the National Intramural-Recreational Sports Association in attached sheet.

(The citations and examples used in the first section of this in this outline derive largely from an article on unrelated business income taxation prepared by the Newton, Massachusetts, law firm of Hurwit & Associates)