

The following is for use by assistive readers and users who prefer a text version of this course.

Unrelated Business Income Storyline /Narration

Slide 1

Leagle – Welcome to the Unrelated Business Income Course.

This course is presented by the Exempt Organizations division of the IRS.

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Leagle: Hi. I'm Leagle, the StayExempt Eagle, and I'll guide you through the courses here at StayExempt.

Before you start, there are a few things to keep in mind. First, if you like to take notes, you might want to print this course first. The printout may make it easier to follow along, especially if you haven't taken many online courses.

Next, if you have any difficulty navigating the courses here at StayExempt, feel free to take a look at our navigation tutorial.

Also, this course includes questions and activities that test your knowledge. You'll be instructed to click on the screen to answer the questions and participate in the activities.

Select the Objectives button to begin learning about Unrelated Business Income.

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Leagle: In this course we'll talk about Unrelated Business Income for Section 501(c)(3) organizations or UBI, for short. Section 501(c)(3) organizations may need to report and pay tax on UBI, so it's important to recognize it.

You'll also learn the three-part UBI definition, the exceptions and exclusions to UBI, and the deductions available when calculating tax on UBI.

We'll end this session with information on how and when to report your organization's UBI and how to pay the income tax due.

First, let's learn the basics of UBI. Select the Introducing UBI button to continue.

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Vernon: Hi, I'm Vernon, I joined the Highland Middle School Parent Teacher Organization to help at my grandson's school. Now I serve as the treasurer - and prepare the PTO's tax forms, including Form 990-T for reporting unrelated business income from the school's fundraising activities. Problem is, I'm having trouble determining which activities generate UBI and which don't. I'm never sure if I'm right.

Leagle: Hi Vernon. Yours is a very common problem. First, let me point out that the main benefit of tax-exempt status is that your organization isn't taxed on income from an activity that furthers its exempt purpose.

Vernon: Exempt purpose? What's that?

Leagle: Your organization's "exempt purposes" will be one – or more – of the eight purposes described in Section 501(c)(3) of the Internal Revenue Code. "Charitable," "Educational" and "Religious" are the big three, but there are five others. To learn more about exempt purposes, take the Applying for Section 501(c)(3) Tax-Exempt Status Overview course. You can always find the list of exempt purposes on the IRS website as well.

The Internal Revenue Code has a three-part definition, or test, describing when income from an activity of an organization might be taxable. Select the Continue button to learn about the UBI definition.

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Vernon: So what does our exempt purpose have to do with UBI?

Leagle: Well Vernon, it's used in the following UBI definition: For income to be considered unrelated business income, it will come from (1) a trade or business that is (2) regularly carried on and (3) is an activity that's NOT substantially related to accomplishing the organization's exempt purpose.

Let's cover each part. Select the Trade or Business button to begin.

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Vernon: Like I said, my organization is a PTO. That doesn't seem like a business at all. How does anything we do qualify as a trade or business?

Leagle: A trade or business generally includes any activity carried on for the production of income from selling goods or performing services.

Vernon: Any activity that produces income?

Leagle: Exactly. Do you sell memberships to the PTO?

Vernon: We sure do.

Leagle: Then that – selling the memberships – is a trade or business activity. But because the memberships are directly related to your organization's exempt purpose, income from those memberships won't create unrelated business income.

Remember, the third part of the definition says the income has to be unrelated to your exempt purpose to be considered UBI. We'll talk more about the third part of the test a little later.

Vernon: So it's ok to run a trade or business as long as what we're selling furthers our exempt purpose?

Leagle: Yes, generally that's right. Sometimes, though, an organization conducts a group of similar activities where some of the activities aren't related to an exempt purpose. The activities that are not related might generate UBI even though they are similar to the related activities.

Let's take a look at an example and see if you can tell if it's a trade or business generating UBI. Select the Case Study button to try it out.

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Leagle: Marion works at a tax-exempt hospital pharmacy that furnishes drugs to its patients in accordance with prescriptions written by doctors on the hospital's staff. If Marion also fills prescriptions for the general public who are not patients of the hospital - is that an unrelated trade or business?

Select an answer, then click the submit button to check it.

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Leagle: Let's try another one: A charity publishes a regular newsletter about the activities that relate directly to its purpose. Additionally, the organization sells advertising space in the newsletter to commercial businesses. Is selling the advertising an unrelated trade or business? Select the best answer, then select the submit button to check it.

Or

Let's try another one: Marion's tax-exempt hospital publishes a regular newsletter about the activities that relate directly to its purpose. Additionally, she also sells advertising space in the newsletter to commercial businesses. Is selling the advertising an unrelated trade or business? Select the best answer, then select the submit button to check it.

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Vernon: Ok, so I think I get the idea of what a business or trade is. But how about the second part of the UBI test – “regularly carried on?” How often does the activity have to happen to meet this part of the test? Every day? Every week?

Leagle: In most cases, if the activity shows frequency and continuity - and is conducted the same way that a non-exempt organization would run a similar business, it's regularly carried on.

Vernon: Hmmm. OK---do you have an example for me?

Leagle: Sure! Here's one. See if you can answer this example:

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Leagle: A hospital auxiliary operates a health food stand for one week at a preventative health education conference. Is this a regularly conducted activity?

Select the best answer, then select the Submit button to check it.

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Vernon: Okay, I understand that an activity must produce income and happen on a regular basis to be considered UBI. You said you were going to talk more about the third part of the test – are we ready for that now?

Leagle: You bet we are, Vern! The third part of the test focuses on whether a regularly-occurring, income-producing activity actually furthers the exempt purpose of the organization. If the activity isn't closely related your exempt purpose, any income it produces will be UBI.

For example, the exempt purpose of a school is to provide education on a subject. Even if a school publication is for the purpose of educating the students, selling advertisements appearing in the publication would be considered unrelated – and generate UBI.

Any income-producing activity that doesn't directly further your organization's exempt purpose, other than by raising funds, could generate UBI.

The key thing here is not the DESTINATION of the income, but the SOURCE of the income This means that even though an organization uses income from a particular activity to further its charitable purposes, that doesn't make the activity substantially related to its exempt purposes. .

Vernon: So anything we sell only for the purpose of raising funds could be generating UBI?

Leagle: That's right.

Vernon: How do I figure out if an activity is sufficiently related to my exempt purpose?

Leagle: That can depend on the size and extent of the activities in comparison to the nature and extent of the exempt function they intend to serve.

There are several principles that help determine if an activity is substantially related to an organization's purpose. Let's go over those next. Select the UBI Principles button.

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Vernon: So, what are the principles to determine whether my activity is significantly related to my organization's exempt purpose?

Leagle: Let me list them first, then I'll give you more information about each. The principles are: Selling products of exempt functions; Dual use of assets or facilities, and exploitations of exempt functions.

Select the Selling Products button to move forward.

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Leagle: Ordinarily, selling products that result from the performance of exempt functions is not an unrelated trade or business if the product is sold in substantially the same state it was in when the exempt functions were completed. An example would be an exempt organization that engaged in rehabilitating handicapped individuals, then sold the items made by the patients as part of their rehabilitation training. This is not considered an unrelated trade or business.

However, if a finished product is used or manipulated after completion, beyond what is reasonably appropriate or necessary to use as it is, the activity is an unrelated trade or business. For example, if an exempt organization maintains an experimental dairy herd for scientific purposes, the sale of milk and cream produced in the ordinary course of operation of the project is not an unrelated trade or business. But, if the organization uses the milk and cream to manufacture items like ice cream or yogurt, the sale of these products is an unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

Sometimes facilities can have more than one function which may affect how the UBI calculations for your organization. Select the Dual Use button to learn more.

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Leagle: While some of your assets or facilities may be necessary for your organization to conduct your exempt function, these assets or facilities may have a dual use. Some may be used both for exempt and commercial functions. The use of an asset or facility for exempt functions does not, by itself, make the commercial activities an unrelated trade or business. The test, as discussed earlier, is whether the activities contribute importantly to the accomplishment of your exempt purposes.

For example, a museum has a theater designed to show educational films in connection with its public education in the arts and sciences program. The theater is a principal feature of the museum and operates continuously while the museum is open to the public. If the organization also operates the theater as a motion picture theater for the public when the museum is closed, that activity would be an unrelated trade or business.

Select the Exploitation button to continue.

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Leagle: Exempt activities can sometimes create goodwill or other intangible circumstances that can be exploited in a commercial way. When an organization uses these intangibles in a commercial way, the fact that the income depends upon an exempt function does not automatically make the activity related to their exempt function. It could be considered UBI.

Vernon: Whoa. That sounds like it came right out of an IRS regulation. Can you give me an example?

Leagle: I sure can. Let's say a tax-exempt scientific organization enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of laboratory equipment to manufacturers. Endorsing laboratory equipment does not contribute importantly to accomplishing any purpose the organization may have, so, the sale of endorsements is an unrelated trade or business.

Remember, unless the commercial exploitation contributes importantly to the accomplishment of the exempt purpose, the commercial activities are an unrelated trade or business and may qualify as UBI.

Now, let's try to put it all together. Select the Case Study button.

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Example: Let's try a scenario to demonstrate all three parts of the UBI test:

Richard's exempt organization, operated for the prevention of cruelty to animals, offers pet boarding services to the general public year round. Is the income from the pet boarding and grooming services subject to UBI even though the income is used to further the exempt purpose?

Remember the three test to determine if the activity may generate UBI:

1. Is the activity a trade or business?
2. Is it regularly carried on?
3. Is it substantially unrelated to the exempt purpose of the organization?

If the answer to all three questions is yes, the activity may generate taxable unrelated business income.

Select an answer then select the Submit button to check it.

The boarding and grooming services do qualify as regularly-carried-on trade or business because they are offered year round and are offered to the public. In addition, they are not substantially related to the prevention of cruelty to animals even though the income generated is spent on furthering that purpose.

Remember the three tests to determine if an activity may generate UBI: Is the activity a trade or business? Is it regularly carried on? And is it substantially unrelated to the exempt purpose of the organization? If the answer to all three questions is yes, the activity may generate taxable Unrelated Business Income.

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Content Continued:

Incorrect Feedback: OK, you responded "No" to one or more of the UBI test questions. However, based on the information that Vernon provided, this activity could generate UBI because:

- (i) Selling Christmas trees (a good) to the public is a trade or business,

- (ii) Conducting the activity in a seasonal manner means that Vernon's organization likely competes with commercial organizations during the same season, making it regularly carried on, and
- (iii) Selling Christmas trees does not contribute importantly to furthering the organization's exempt purpose of animal rescue.

Vernon - I can't decide whether one of my PTO's activities generates UBI. Maybe you can help. Every year from Thanksgiving to Christmas Eve, the volunteers of my organization sell Christmas trees to the public. The stall is set up in the school's parking lot. Seasonal activities like this go a long way to boosting annual income.

Leagle - Remember the three tests to determine if an activity may generate UBI - Is the activity a trade or business? Is it regularly carried on? And is it substantially unrelated to the exempt purpose of the organization? If the answer to all three questions is yes, the activity may be UBI.

Select an answer then select the Submit button to check it.

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Management or similar services –

Management or similar services provided to other individuals or organizations may generate UBI if the services do not further the organization's exempt purpose. For example, fees from a parking lot used by members and visitors while attending the organization's activities would not be subject to UBIT. On the other hand, if the same organization's parking lot is open to the general public, then parking fees would be taxable because the activity—charging a fee for public parking—would not be substantially related to the organization's exempt purpose.

Leagle: So Vernon, do you feel like you have a handle on what activities would qualify as unrelated business income?

Vernon: I have a better idea, yes, but there are a lot of activities I'm still not sure about.

Leagle: Here are a few of the types of activities organizations often have questions about. These come from the IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations. There are lots more examples in the publication, so check it out later.

Once you've looked at all of the examples, select the Recap move ahead.

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Leagle: Let's go over what you've learned so far.

First, the definition of Unrelated Business Income, or UBI, is income generated from regularly-carried on activities that are not substantially related to an organization's exempt purpose. A 501(c)(3) organization may have to report its UBI, as well as calculate and pay income tax on it.

We talked about each of the three parts of the UBI test. In that test, you identify UBI generating activities by determining if the activity is a business or trade, if it is regularly carried on, and if it is not substantially related to the organization's exempt purpose.

Now let's put your new knowledge to work with a little test. Select the Knowledge Check button to continue.

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Leagle: Here's a question about the Three-Part test. Select the best answer – and when you're done, select the "submit" button to check your answer.

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Leagle – Great job! Next, let's talk about the exceptions and exclusions to the basic test. After that, we'll cover the deductions you can take from UBI before calculating the amount of tax you owe on it.

Select the Continue button to move forward.

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Leagle: The Internal Revenue Code contains a number of exceptions to the usual rules of UBI. In other words, an activity that otherwise meets the three-part test for UBI won't be treated as UBI if one of these exceptions applies.

In addition to these exceptions, the Code excludes certain other types of income from UBI. Let's go over all of these one-by-one.

Select the Exceptions button to learn more.

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Distribution of low-cost articles: When soliciting donations through the mail, Section 501(c)(3) organizations sometimes include incidental items like greeting cards to encourage the recipient to make a donation and the recipient is allowed to keep the item. The term unrelated trade or business does not include activities relating to the distribution of a low cost article incidental to soliciting charitable contributions.

To qualify as "low-cost," the item must cost the organization no more than \$9.70., This value, however, is subject to change each year.

Vernon: So, you mentioned that some activities meeting the three part test are excluded from the definition of unrelated trade or business. What are those?

Leagle: Here's a list of some common exceptions. Select each item to learn more about it.

When you're done looking through the examples, select the More Exceptions button to learn more.

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Leagle: There are also exceptions for qualified convention or trade show activities, sponsorships and Bingo. We will discuss each one separately. Select the Conventions button to start.

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Vernon: Our PTO's board members attend an annual convention where we learn about new initiatives in the field. Does the organization that hosts the convention treat the registration fees as UBI?

Leagle: No, they don't, because of the "convention or trade show activity" exception. But not every kind of convention or conference qualifies for this exception. To qualify, the purpose of the meeting must be to promote and stimulate interest in the products and services of a particular organization or industry. The purpose of the meeting may also be to educate attendees on issues of a particular industry.

Next, let's talk about sponsorships. Select the Sponsorship button to continue.

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Vernon: Can you explain the sponsorship exception?

Leagle: Sure. The sponsorship exception applies to payments made to an exempt organization by an individual or company when the person or company doesn't receive any substantial benefit, other than the use or acknowledgement of the contributor's name, logo or product line in connection with the organization's activities.

An example would be a contribution by a company to an exempt organization that sponsors a collegiate post-season football game. In return for its sponsorship payment, the company gets its name included in the title of the game.

Finally, let's talk about Bingo. Select the Bingo button to continue.

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Vernon: I see that income from bingo games may be eligible for a special tax exception.

Leagle: That's right. But just calling a game "bingo" doesn't mean it will automatically qualify for the exception. To qualify, the game must be the traditional type of bingo, where all wagers are placed, all winners determined, and all prizes awarded in the presence of all persons playing in that game. In addition, the game must be legal under state and local law, and played in a jurisdiction where bingo games aren't regularly conducted by for-profit organizations.

"Charitable gaming" is a big topic all on its own - and can raise UBI considerations for organizations that conduct it, so we've created a separate Charitable Gaming [\[link\]](#) course here at StayExempt. You might want to check it out when you're done with this course.

Select the Interests/Dividends button to move forward.

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Vernon: So, that covers all the major exceptions you mentioned.

Leagle: Yes. Besides those, the Code provides some other exclusions from unrelated business income.

Interest and dividends are excluded, including interest from bank accounts, annuities, payments with respect to securities loans, and any other incomes from routine investments, including notional principal contracts.

Next, select the Royalty Income button to learn more.

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Vernon: I've heard about the exclusion for royalties, like the payments you'd get from publishing a book.

Leagle: Right. Royalties are payments for the use of a right, such as a trademark, trade name or copyright. You get royalties from a book because the book is protected by copyright. But, when an exempt organization is required to provide substantial services as a part of the agreement to use a right, the payment the exempt organization receives isn't considered a royalty, but a payment for services.

Let's talk about another exclusion – rent from property. Select the Property Rent button to move forward.

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Leagle: Generally, income from the rental of real property is excluded when calculating UBI. There are a couple situations, however, where rental income would be considered UBI:

- If an organization rents out property where there is debt – or mortgage – then a portion of the rental income may constitute UBI subject to tax.
- If the organization rents personal property or provides management services in connection with the rental, then the income may be UBI subject to tax.
- Income from the rental of personal property, such as computer equipment, isn't excluded from UBI.

For example, let's say your exempt organization rents out an assembly hall for special events. As long as your organization wholly owns the building and provides no additional services such as bartending, you can exclude the rental received from your taxable income.

There's one more exclusion we should talk about - gains and losses from property sales. Select the Property Sales button to learn more.

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Leagle: Another exclusion from UBI are gains and losses from the sale of property.

Vernon: That should include the gains on the sale of stock, right?

Leagle: Exactly.

The one exception is inventory and property held primarily for sale in the course of a regular trade or business. You can't exclude income on items you sell on a regular basis. If you purchase inventory with the intention of selling it at a profit, that's a trade or business activity. That's different from making a profit on a building you purchased for exempt-function use or a stock you purchased as an investment.

Now let's test you on what we've covered. Select the Knowledge Check button to move forward.

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Leagle: Select the answer that best completes this sentence: The IRS Code excludes some types of taxable income that might be considered UBI. Some of these exclusions include:

When you're done, select the Submit button to check your answer.

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Vernon: So, once you've factored out all the exceptions and exclusions, you can apply deductions to whatever income is left over?

Leagle: Right, deductions should be done last. The calculation of unrelated business taxable income is similar to the calculation of other income tax in that UBI can be offset by expenses related to the production of the income.

Here are some of the deductions that are allowed.

Any expenses, depreciation and similar items that are allowable income tax deductions directly connected with carrying on the unrelated trade or business.

An exempt organization can also deduct charitable contributions it makes to other qualified charitable organizations.. This deduction is limited to 10% of its UBI.

Also, your organization can take a net operating loss deduction in calculating its UBI. This deduction is allowed in one tax year based on a loss generated in either a previous or subsequent tax year.

Finally, you can take a specific deduction of \$1,000 in calculating UBI. This is similar to the personal exemptions allowed on 1040 returns.

Select the Filing Form 990-T button to move forward.

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Vernon: Now that I have a basic understanding of UBI, how do I report it to the IRS?

Leagle: When gross UBI equals or exceeds \$1,000, an organization must file Form 990-T, Exempt Organization Business Income Tax Return. If an organization's total anticipated tax for the year equals or exceeds \$500, it has to pay a quarterly estimated tax using Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations. Failure to file the forms may mean penalties. The return must be filed by the fifteenth day of the fifth month following the end of the organization's tax year.

Vernon: What happens if I need an extension?

Leagle: You can request an extension by filing Form 8868, Application for Extension of Time To File an Exempt Organization Return, by the original due date. If you're a corporation, you can request an automatic 6-month extension. If you're a trust, you can request an automatic 3-month extension and, if necessary, an additional 3-month extension that'll be granted at the IRS's discretion.

There's more detailed information on all of this in the Instructions for Form 990-T. Be sure to read up on it there.

Finally, let's review everything we've done in this section. Select the Recap button.

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Leagle: So let's go over what you've learned so far.

First, we covered exceptions, which are activities that – even though they pass the three part test – won't be treated as taxable income – or UBI. These include: volunteer workforce, convenience of members, sale of donated merchandise, distribution of low-cost articles, convention or trade show activity, sponsorship and bingo.

Next you learned about exclusions, which are other income generating activities also generally excluded from UBI. These are interest/dividends, royalty income, rent from property and gains/losses from sales of property.

Then you learned about the deductions that can reduce UBI tax liability, how to fill out form 990-T, and when to file it.

So, let's test your knowledge.

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Leagle: When an exempt organization reports unrelated business income, it must file what?

When you're done, select the Submit button to check your answer.

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Leagle – Great job! You have completed the Unrelated Business Income course! Select the Continue button to move forward.

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Leagle: There were a lot of resources in this course, so feel free to go back through it. Here are some links to the major resources in this course. Click on the Continue button when you're done.

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Leagle: On behalf of everyone in the IRS Exempt Organizations division, thank you for taking the Unrelated Business Income Course. Before you leave, please take a couple of minutes to send feedback for the Exempt Organizations team, feel free to [send us an email](#).

After you complete this review, print out your own [Certificate of Completion](#) as recognition for attending.