Stay Exempt

Course 2 Summary: Unrelated Business Income

UBI & the UBI Test

UBI is income from a **regularly-carried-on trade or business** that is **not substantially related** to the organization's exempt purpose

To generate UBI, the activity must be:

- A trade or business,
- Regularly carried on, and
- Not substantially related to the organization's exempt purpose.

These three requirements form the three facets of the UBI test. To be considered a source of unrelated business taxable income, an activity must conform to each of the three facets.

Trade or business means selling goods or services to generate income.

Regularly carried on means the activity shows frequency and continuity and that it is conducted in the same way that a non-exempt organization would run a similar business.

Not substantially related means that the activity is not important to furthering the exempt purpose of the organization (other than generating income for it).

Exceptions to UBI

The Internal Revenue Code contains a number of exceptions to the usual rules of UBI. That means that some UBI is not subjected to tax. These exceptions include, but are not limited to, activities:

- Conducted by a volunteer workforce,
- Conducted for the convenience of organizational members,
- Involving the sale of donated merchandise,
- Involving the distribution of low-cost articles,
- Involving income from convention or trade show participation,
- Involving income from qualified sponsorship, and
- Traditional bingo.

Exclusions and Deductions from UBI

In addition to the exceptions discussed, the Code allows certain other exclusions and deductions in calculating UBI tax.

The exclusions include, but are not limited to, income generated from:

- Interest and dividends,
- Royalties,
- Certain rents from real properties with the exception of income from debt-financed property, and
- Certain gains and losses.

Allowable deductions include certain expenses, depreciation, and similar items directly connected with carrying on an unrelated trade or business. In addition, other modifications allow for deductions like:

- The **net operating loss deduction**, where an unrelated business loss in a previous or current tax year is deductible;
- **Charitable contributions** made by the organization regardless of whether

they are directly connected with the unrelated trade or business; and

- The **specific deduction** that allows for $1,000 to be automatically deducted from the UBI tax calculation.

Charitable Gaming and Applicable Taxes

A small amount of unrelated trade or business activity in relation to an organization's exempt purpose activity will have no impact on exempt status. Exempt status is only jeopardized when the activity generating unrelated income makes up a substantial part of the organization's overall activities.

Gaming is one of the most common and successful types of fundraising. It can range from sponsoring a bingo game to a once-a-year raffle or casino night.

Most often, gaming will generate UBI. Federal wagering excise taxes apply to certain types of gaming, but these taxes are typically not applicable to gaming conducted by 501(c)(3) organizations.

Certain wagering transactions also require Form W-2G to be filed. The gaming operator should always complete Form W-2G upon payment of the prize to the winner.

Withholding or backup withholding of income tax from the prize winner is reported on Form **W-2G**. The rates and requirements of withholding depend on the game played and whether the winner furnishes taxpayer identification at the time the prize is awarded.

Withheld income tax is reported annually on **Form 945**, Annual Return of Withheld Federal Income Tax.

Filing Procedures for Form 990-T

Organizations with gross income of $1,000 or more from unrelated business must file Form 990-T annually.

Form 990-T is due the 15th day of the 5th month following the end of the organization's accounting period.

Form 8868 can be used to request an automatic six-month extension of time to file Form 990-T.

Form 990-W is used to make installment payments when estimated tax is expected to be $500 or more.

Form 990-T must always be filed in conjunction with Form 990. One cannot replace the other.