

The Fourth Way to Sink Your Tax Exemption: Too Much Unrelated Business Income

04.23.15 | Linda J. Rosenthal, JD



In “[5 Ways to Sink Your Tax Exemption](#),” we listed the sure-fire ways to jeopardize your 501(c)(3) tax-exempt status.

We’ve already introduced four of them: (1) political activity; (2) too much lobbying; (3) not filing Form 990s; and (yeah, we didn’t post them in order) (5) too much private benefit.

So what’s number four? Actually, you might easily overlook it, too. It’s too much unrelated business income.

What Does “Unrelated Business Income” Mean?

Many 501(c)(3) public charities receive their support from donations from the general public or government grants. But what happens when these groups generate income from business-type activities — like selling products or services, for example?

Generally, it’s legal, and the organization will not be taxed on this income if the activity is “substantially related” to the charity’s exempt purposes. This revenue remains exempt from income tax even if the activity looks like a business.

But if the group regularly runs a trade or business that is “not substantially related” to its exempt purposes — (except that it provides funds to carry out those purposes), the organization is subject to a special tax called the unrelated business income tax.

The devil is in the details, though, and many of the tricky issues arise in connection with the definition of what is or is not “substantially related” to an organization’s exempt purposes.

Of course, because the question is how the income-generating activities relate to a particular exempt organization’s purposes, it is a highly fact-specific determination that takes into account all

of the circumstances.

Here's how the IRS explains this third part of the three-prong test:

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A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose (other than through the production of funds).

Well, that helps, doesn't it? Not much? Here's more:

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Whether an activity contributes importantly depends in each case on the facts involved.

Still not much help. Here's even more:

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In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve. For example, to the extent an activity is conducted on a scale larger than is reasonably necessary to perform an exempt purpose, it does not contribute importantly to the accomplishment of the exempt purpose. The part of the activity that is more than needed to accomplish the exempt purpose is an unrelated trade or business.

These rules are probably best explained by examples. Here are a few from the same IRS publication. In each situation, the activity is “substantially related” to the organization's exempt purpose, so there is no unrelated business income tax.

Halfway House Workshop:

An organization's stated exempt purpose is to provide a supportive, therapeutic residence for people discharged from alcohol-treatment centers. It operates a furniture shop to provide them full-time employment. Profits from the shop are applied to cover operating costs of the halfway house.

This activity “contributes importantly” to the purpose of aiding the residents' transition from treatment to a normal and productive life, so there is no unrelated business income tax.

Hospital Sales of Hearing Aids:

A tax-exempt rehabilitation hospital tests and evaluates patients with hearing problems. It sells hearing aids to them.

This activity is an “essential part” of the hospital’s program, and “contributes importantly” to its exempt purposes, so there is no unrelated business income tax.

Youth Residence by Welfare Organization:

A youth-welfare group runs on-site social, recreational, and guidance programs managed and supervised by trained professionals. It also rents out rooms in its building to people primarily under age 25.

This rental activity “contributes importantly” to its exempt purposes, so there is no unrelated business income tax.