

The "Trade or Business" Test: Does It Quack Like a Duck?

12.29.15 | Linda J. Rosenthal, JD



The hallmark of a 501(c)(3) public charity is that it receives enough support from donations or grants to make it accountable to the public good. But many 501(c)(3)s also generate income from business-type activities – like selling products or services.

Generally, this is fine – and won't jeopardize the tax exemption. But if the scope of the business-type activities is too big compared with the nonprofit's exempt, charitable activities and purposes, that can spell trouble.

What kind of trouble? An excise tax; that is, the unrelated business income tax, commonly referred to as "UBIT."

Unrelated Business Income Tax

In "[The Fourth Way to Sink Your Tax Exemption: Too Much Unrelated Business Income](#)," we first dipped our toes into the UBIT waters.

This [special](#) excise tax on unrelated business income may apply if an activity meets *all three* of these factors:

- (1) it constitutes a "trade or business",
- (2) it is "regularly carried on," and
- (3) it is *not* "substantially related" to the charity's exempt purposes.

The Internal Revenue Service publishes a helpful guide to UBIT: Publication 578. In the Introduction to Pub 578, these three factors are explained both backward *and* forward:

(Backward:) An exempt organization is not taxed on its income from an activity substantially related to the charitable, educational, or other purpose that is the basis for the organization's exemption. Such income is exempt even if the activity is a trade or business.

(Forward:) However, if an exempt organization regularly carries on a trade or business not substantially related to its exempt purpose, except that it provides funds to carry out that purpose, the organization is subject to tax on its income from that unrelated trade or business.

What is a “Trade or Business” Under the UBIT Statute?

The least complicated prong of this 3-part test is the meaning of a “trade or business.” It’s fairly easy because the approach of the IRS is along the lines of: “If it looks like a duck, and quacks like a duck, then” The term ‘trade or business’ generally includes any activity conducted for the production of income from selling goods or performing services....An activity must be conducted with intent to profit to constitute a trade or business.” So far, so good. The term “trade or business” here is roughly the same as that term is used in the income tax rules to determine deductibility of business expenses. Quack, quack. And even if the “trade or business” doesn’t actually generate a profit in a particular year, it can still be a “trade or business” for purposes of this test.

One Special Situation

A common scenario – a variation – is worth mentioning here:

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An activity does not lose its identity as a trade or business merely because it is conducted within a larger group of similar activities that may or may not be related to the exempt purposes of the organization.

Pub 578 gives an example (from the federal tax regulations) that’s fairly straightforward: a hospital pharmacy open to the general public:

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The regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose.

The quacking sounds are heard only in the pharmacy; that is, the “trade or business.” No ducks are spotted wandering around the hospital operating rooms or the maternity ward.

Conclusion

There are exceptions, of course – as well as exceptions to the exceptions.
This is a complicated statute.