Unrelated Business Income of Nonprofit Organizations

Introduction

Generally, a tax-exempt organization with gross income of $1,000 or more for the year from an "unrelated trade or business" is subject to the "unrelated business income tax." An unrelated trade or business is one which has little or no relationship to the organization's tax-exempt purposes, except to provide funds to carry out those purposes. The provisions for taxing income apply only if the trade or business is *regularly carried on* and *is not substantially related* to carrying out the exempt purpose for which the organization exists. Certain types of activities are excluded from the definition of an unrelated trade or business. For example, a business is not considered as unrelated if it is conducted mainly with volunteer labor, carried on primarily for the convenience of organization members, produces income from selling donated merchandise, or operates legal bingo games, as specified in the Internal Revenue (IR) Code.

The taxation of gross unrelated business income was designed to place the unrelated activities of exempt organizations on an equal footing with similar activities carried out by taxable entities, such as nonexempt corporations. Although their unrelated business income is taxed, exempt organizations may enter into a wide range of nontaxable commercial activities if they are substantially related to their tax-exempt missions.

For 1997, an estimated 39,302 organizations reported aggregate gross unrelated business income (UBI) of $7.8 billion. After offsetting this income with $8.5 billion of total deductions, the resulting overall deficit was $0.7 billion. However, 53 percent of the organizations had net taxable profits, which collectively amounted to $1.4 billion. Nonprofit organizations reported an aggregate total income tax liability of $422.7 million for 1977. Between 1996 and 1997, taxable profits rose 18 percent. This increase was much smaller than the annual increases in taxable profits that occurred between 1994 and 1996. Over that period, these profits rose 39 percent from 1994 to 1995 and then another 31 percent from 1995 to 1996.

Articles and tables included in this section provide extensive information on unrelated business income, deductions, and taxes for Tax Years 1991 through 1997, as collected from samples of Forms 990-T, *Exempt Organization Business Income Tax Return*. Organizations with gross UBI between $1,000 (the filing threshold) and $10,000 file a "partial" Form 990-T, whereupon they are not required to provide detailed deduction items or to fill out the form schedules. All other organizations file a "complete" Form 990-T. The return schedules are used to compute cost of sales and services and also to determine unrelated business income received from rents, debt-financed property, investments (IR Code section 501(c)(7), (9), and (17) organizations only), controlled organizations, exploited exempt activities, and advertising. In addition to income statement and tax information, the Form 990-T provides descriptions of principal unrelated business activities carried on by nonprofit organizations, based on industry codes provided in the tax form instructions.

This third volume of the *Compendium* is the first to contain a time series of Form 990-T unrelated business income statistics. Beginning with Tax Year 1993, the Form 990-T study incorporated a special "integrated" sampling technique to gather information on "related" (tax-exempt) and "unrelated" (taxable) income and expenses for organizations that filed both Form 990 (*Return of Organization Exempt From Income Tax*) and Form 990-T. The integrated sampling program ensured that the Form 990-T sample included any unrelated business income tax returns filed by organizations whose Form 990 information returns were selected for the Statistics of Income (SOI) samples of charities (IR Code section 501(c)(3) organizations) and other tax-exempt organizations (IR Code section 501(c)(4) through (9) organizations).

The matched records provide the means for consistency in analyzing exempt-function and nonexempt-function income and expenses of organizations that are involved in unrelated business activities. Some of the articles included in this section have used the matched Forms 990 and 990-T to explore the extent to which various types of exempt organizations engage in unrelated business activities. Because of budget reductions, the Tax Year 1996 Form

990 sample was limited to include only the section 501(c)(3) charitable organizations for that year, therefore restricting the integrated portion of the Form 990-T sample to these types of organizations. The section 501(c)(4) through (9) returns were reinstated to the Form 990 sample for 1997 and later years, but the integrated portion of the Form 990-T sample remains based on section 501(c)(3) organizations only.

Up until Tax Year 1996, the types of organizations that were subject to the unrelated business income tax (UBIT) provisions included those described in sections 501(c)(2) through 501(c)(25), as well as qualified pension, profit-sharing, and stock bonus plans described in section 401(a), Individual Retirement Arrangements (IRA's) described in section 408(e), and cooperative service organizations described in sections 501(e) and 501(f). For 1997, the UBIT provisions additionally covered Medical Savings Accounts described in section 220(e), although none of these organizations were selected for the Form 990-T sample for that year. For 1998, the UBIT provisions added Roth IRA's described in section 408A, Qualified State Tuition Plans described in section 529(a), and Education IRA's described in section 530(a).

Program Developments

Beginning with Tax Year 1998, the Standard Industrial Classification (SIC)-based industry codes that Form 990-T filers used to describe their unrelated business activities were replaced with the North American Industry Classification System (NAICS) codes. New programming has been added to SOI's Form 990-T data entry ("editing") system to automatically change a SIC code reported on Form 990-T to a cross-referenced NAICS code. Another system enhancement aids data entry personnel in determining the correct IR Code section for an organization when the section reported by the taxpayer differs from that contained on the Internal Revenue Service's "Master File." An automated look-up list showing previously researched correct codes ensures consistency in statistics presented by type of organization across study years.

SOI's return processing system for the annual unrelated business income studies were converted to a Graphical User Interface (GUI) application, starting with Tax Year 1999. This application updated the editing system to a point-and-click windows environment, which is more user-friendly to the study "editors," who are responsible for entering information from the returns and resolving data inconsistencies and taxpayer reporting errors.

Source: IRS; Compendium of Studies of Tax-Exempt Organizations, 1989-1998; Volume 3, Publication 1416; August 2002