



The Foundation Group: Nonprofit Unrelated Business Income Explained

<https://www.501c3.org/nonprofit-unrelated-business-income/>

By Greg McRay, EA, October 14, 2024

There are few topics that generate more confusion to nonprofit managers than unrelated business income (UBI). It is also one of the areas that can cause the most problems for your organization. It can cost you money in the form of taxes. It could potentially cost your tax-exempt status if not properly handled. Let's take a look at what constitutes UBI, and how best to handle it if your nonprofit chooses to go down this route.

Definition

The Internal Revenue Service defines *Unrelated Business Income* as:

Income from a trade or business that is regularly carried on by an exempt organization and that is not substantially related to the performance by the organization of its exempt purpose or function, except that the organization uses the profits derived from this activity.

I'm being generous when I say that the IRS has a way of wording things in a less-than-clear manner. Another way to say it is: *Unrelated Business Income* is money generated from any on-going activity of your organization when the activity itself does not directly further the organization's exempt purpose.

Key Points About UBI

While I may prefer my own paraphrased definition, there are some key words and phrases in the IRS definition worth pointing out and expanding upon.

Income from a trade or business. Nonprofits often have a variety of income sources, including [donations](#), revenue generated by program activity, or maybe even investment income. UBI is income generated by commercially-equivalent activity, meaning, your organization is providing goods or services in a commercial or business-like manner.

Regularly carried on. This distinction is important, especially as it's compared with short-term fundraisers. To be classified as UBI, this [selling of goods](#) and/or services must be an on-going activity. It need not be a year-round activity to tip into UBI territory, but it will be sales that are a regular fixture of the organization, occupying a significant part of the calendar.

Did you ever wonder why the Girl Scouts only sell their cookies a few weeks each spring? They could make a lot more money if they were available year-round, right? But selling cookies is not a charitable purpose. To do so continually as a tax-exempt organization would put the Girl Scouts in a competitive advantage over other cookie producers.



Not substantially related...to the organization's purpose. This is ultimately what it comes down to. I just mentioned above that selling cookies is not a charitable purpose. The purpose of the Girl Scouts is fundamentally educational. Selling cookies is a commercial activity with no charitable outcomes (outside satisfying your sweet tooth!), and beyond the cash generated, does not in any way further the Girl Scouts mission directly.

Examples

Here are some other income-generating activities to consider. UBI or not UBI?

Example 1.

A community performing arts organization charges admission to its quarterly productions. The stated purpose of the organization is to promote the performing arts to the community and to teach performance art to the participants. The organization conducts quarterly plays and recitals for the public, charging \$10 per attendee. Tickets are available for each performance at least 45 days prior to the event.

Let's look at each of the three UBI hallmarks.

Trade or business activity – Well, it IS sales activity. The nonprofit is selling tickets to the public.

Regularly carried on – Yes. Even though it's not all year long, tickets are being sold a significant portion of the year.

Not substantially related – Here is why this activity is NOT unrelated business income. The [organization's purpose](#) is arts promotion, education, and appreciation. Selling tickets to the public to see this arts expression is fully related to the nonprofit's charitable purpose, thus, this is considered *program revenue*, not UBI.

Example 2.

A [church](#) owns a vacant corner lot next door to its main facility. After studying traffic patterns and demographics, the elders determine that this would be a great location for a convenience store and gas station. It then proceeds to build one and open for business. The store provides a much needed cash infusion to supplement the various charitable programs the church conducts.

Admittedly, this is an extreme and unlikely example, but it gets the point across. Let's again look at the big 3.

Trade or business activity – No question...a convenience store is a commercial business activity.

Regularly carried on – You have to assume it isn't a two-week fundraiser, right?

Not substantially related – Ok, maybe the patrons start praying when they pull up to the pump and



it's nearly \$5 per gallon. But no, there is no charitable, religious purpose to running a corner market.

Hence, UBI on this one.

Exceptions

It's the IRS we're talking about, so you might have guessed that there would be exceptions. If so, you are correct.

Rental Income

Probably the biggest exception is rental income. If a 501(c)(3) organization owns a piece of property, land and/or building(s), and rents that property out to a tenant, in general that revenue stream is not considered unrelated business income. Yes, it is commercial in nature. Yes, it is ongoing. And no, it probably is not directly related to the tax-exempt purpose of the nonprofit. Sounds like 3 strikes, doesn't it?

The reason rental income isn't usually tagged as UBI has less to do with any rules governing nonprofits, and more to do with how rental income is considered by the IRS in general. Rental income usually falls into the category of passive income, as opposed to the active operation of a business. As such, the IRS specifically carves out rental income as not being a UBI-generating activity.

Convenience of Members

This carve out is for sales of goods and services that would otherwise meet the definition of UBI, except for the fact that it is provided exclusively for the convenience of a nonprofit's members. [An example of this might be a university restaurant or coffee shop.](#)

Some Gaming Activities

Games-of-chance, or gambling activity, is often used as a [fundraising tool of some nonprofits](#). While it obviously looks like UBI, the IRS allows it to be considered tax-free revenue, assuming 1) it is legal where the activity is being conducted, and 2) it is being conducted by an organization whose purpose is social or recreational, such as a 501(c)(7). It is also possible to have a charitable nonprofit conduct such activity on an occasional event-type basis and qualify as fundraising activity, and not UBI.

There are certainly more exceptions to this. You can see them all in [IRS Publication 598](#).

Unrelated Business Income is Taxable Income



What are the problems with UBI? Well, the good news is that it is not illegal. The bad news is that it is [taxable income](#). The IRS also requires nonprofits that have unrelated business income activity to have two sets of books, and to segregate all income and expense activity. Of course, any net profits from the UBI activity can (and should!) support the charitable mission. But it's best to keep separate bank accounts and transfer any UBI profits from the business account to the nonprofit's primary operations account before spending it on regular missional expenses.

Key point: Remember to keep enough cash in the [business account](#) to pay federal corporate income tax on your profits. The nonprofit is required to report the income and expense activity on [IRS Form 990-T](#) each year and pay corporate taxes on the net profits...even if all the net profits are used to fund tax-exempt activities.

Unrelated Business Income is Limited

The IRS expects all tax-exempt organizations to operate exclusively for their approved purpose. A 501(c)(3) should be exclusively charitable in its activities. A 501(c)(7) should be exclusively social or recreational. Nonprofits are allowed to have an *insubstantial* amount of activity...activity defined in both terms of programs and income generation...that is not directly tied to that tax-exempt purpose.

Therefore, UBI activity needs to be insubstantial in any nonprofit's overall picture. Too much UBI can result in a loss of tax-exempt status by undermining the organization's exclusive purpose.

But what constitutes substantial vs. insubstantial? In typical IRS fashion, they don't really say in concrete terms where the line is drawn. [In our many years of experience, we're pretty settled on the idea that 20% of income and/or program activity is about the outer edges of what the IRS is going to tolerate.](#) I would even suggest that the typical nonprofit considering UBI-generating activity keep it to 10% or less to avoid unnecessary scrutiny.

Conclusion

More and more, nonprofits are looking for new and creative ways to generate sustainable revenue. And now more than ever, many are even considering non-charitable revenue ideas. Just remember that, while legal, UBI is complicated, it is taxable, and too much of it can cause major headaches.

Most smaller nonprofits should probably avoid UBI if you can. The revenue potential is usually going to be offset by the compliance concerns of doing it right, plus the distraction can undermine your real mission. If your organization determines it simply cannot turn down an opportunity to make a pile of money from unrelated activity, know what you're getting into. Make sure you have a good compliance team, like us, helping you keep it all straight.



COUNCIL
FOR MILITARY SPOUSE CLUBS

3246 Centennial Blvd. #360 | Colorado Springs, CO 80907-4077 | CouncilForMSC.org

The Council for Military Spouse Clubs is a Section 501(c)(3) tax-exempt charitable organization under the Internal Revenue Code and is a registered nonprofit corporation in Colorado. EIN 86-1552088.