

## **UNRELATED BUSINESS INCOME AND ADVERTISING**

A previous issue of MNA Links (August 2001) contained an informative article entitled “Supporting Your Publications with Advertising.” In times of increasing demand for services and concerns regarding decreasing funding, many nonprofit organization leaders are considering additional sources of support. Accepting paid advertising in an organization’s publication can reduce the net cost of the publication and/or provide supplemental income for the organization’s other activities. Once thorough consideration has been given to the practical and strategic issues about advertising as outlined in the August 2001 article, organization leaders should also familiarize themselves with implications raised by the Internal Revenue Code rules about unrelated business income. By being aware of the rules and creating appropriate record keeping, organizational leaders can avoid unpleasant surprises, minimize possible taxation of advertising income, and maximize the benefits of the advertising activity.

### **A. DEFINITION OF UNRELATED BUSINESS INCOME**

In order to understand the tax implications of paid advertising, it is helpful to have an overview of the concept of unrelated business income tax.

While tax-exempt organizations recognized under Code Section 501(c) are generally considered to be exempt from income tax, these organizations are not exempt from tax on all forms of income. In particular, they are subject to tax on unrelated business income. The tax on unrelated business income arose from congressional concerns that for-profit, tax paying, businesses were suffering as a result of unfair competition by tax-exempt organizations.

The rules pertaining to taxation of unrelated business income are found in Internal Revenue Code Section 511 through 514. Under these rules, income is taxable when three elements are present: the income results from a trade or business, the trade or business activity is regularly carried on; and the conduct of the trade or business is not substantially related to the exercise or performance of the organization’s charitable or other exempt purposes.

#### **1. Trade or business**

A trade or business is broadly defined as an activity which is carried on for the production of income from the sale of goods or the performance of services. Generally, an organization’s investment activities on its own behalf are not considered to be a trade or business. There are many types of activities which the Internal Revenue Service may consider to be a trade or business, such as sales activities, insurance programs, travel programs, sale or rental of membership lists, affinity cards, and advertising. Each activity of an exempt organization is considered on its own to determine whether it constitutes a trade or business, even if it is a part of a larger overall endeavor.

#### **2. Regularly Carried On**

A trade or business is regularly carried on if it is conducted with frequency, continuity, and pursued as if it were a comparable commercial activity. Intermittent or infrequent activities are excepted unless they are accompanied by publicity or promotion similar to that of a comparable

commercial venture. An example given by the IRS of an activity that is not regularly carried on is the operation of a sandwich stand for a two-week period concurrent with a fair. Given this, it would seem that where a nonprofit organization publishes only on an infrequent basis, advertising in the publication would not usually be considered to be regularly carried on. However, the Service has taken the position that the inclusion of advertisements in an organization's annual publication might be considered to be regularly carried on if the solicitation, copy design, typesetting, and distribution activities are conducted over a period of several months.

### **3. Not Substantially Related**

In order for a trade or business to be related to an organization's exempt purpose it must significantly assist in, or contribute substantially to, the performance of the exempt purpose. Income from an activity will be considered unrelated if the activity does not otherwise further the organization's exempt purposes, regardless of the organization's need for the income derived from the activity, or the ultimate use of the funds for exempt purposes. For example, the sale of educational items pertaining to natural history by a natural history museum would be a related business, whereas sales of general items such books unrelated to natural history would not be related. This example is also an example of the so-called "frequentation rule" whereby an activity may be broken down into segments to determine whether any portion of the activity may be considered taxable.

## **B. EXCEPTIONS**

Certain specific types of activities are excepted from unrelated business income taxation. Among them are activities in which substantially all of the work in carrying on the trade or business is performed by volunteers. Another is the selling of merchandise, substantially all of which has been received as gifts or contributions. There are also a number of exceptions that apply to very specific types of organizations or activities, such as trade show activities conducted by Code Section 501(c)(6) organizations.

Also, an exception exists for distribution of low cost articles as part of a fundraising campaign where there is no obligation to purchase the articles. Another is the sale or exchange of mailing lists by 501(c)(3) organizations to other 501(c)(3) organizations.

As mentioned above, passive investment income is generally exempted from unrelated business income. In particular, income such as dividends, interest, annuities, royalties, most rents, and capital gains is exempted in the case of most tax-exempt organizations, such as 501(c)(3) organizations. \* However, tax-exempt treatment of investment income is not available for clubs covered under Code Section 501(c)(7) and certain other types of organizations.

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\* Tax treatment of real property rental income can create a trap for the unwary. It should be noted that the exception for rent only applies to the rental of real property. However, this exception pertaining to the rental of real property may not apply where significant services are provided to tenants or where the rent amount is based upon the gross income of the tenants. Similarly, a portion of rents received from real properties which are subject to debt financing are subject to unrelated business income taxation. The debt financed income rules also apply to streams of income on forms of investments other than property. Where income is received from a property or other asset that is debt financed, a thorough understanding of these rules is necessary in order to avoid tax surprises.

## **C. COMPUTATION OF UNRELATED BUSINESS INCOME**

The general definition of taxable unrelated business income is set forth in Internal Revenue Code Section 512(a)(1). This is gross income derived from unrelated trade or business activities regularly carried on, less deductions directly connected with the carrying on of the trade or business computed with certain modifications. Treasury Regulations under this Code Section indicate that these deductions are those which are attributable solely to the conduct of the unrelated business and which are proximately and primarily related to the business activity. Consequently, an organization conducting retail sales may deduct from gross sales income the specific costs of the items sold, as well as the costs of handling, shipping, marketing, and allocable employee costs. In addition, expenses incurred jointly in the conduct of the unrelated trade or business and the general conduct of the organization's exempt purpose may be deducted on an allocated basis from the gross unrelated trade or business income. In other words, portions of an organization's overhead specifically attributable to the conduct of the unrelated activity may generally be deducted from gross unrelated business income. (NOTE: This does not apply to certain advertising income and other income resulting from "exploitation" of an exempt function as discussed below).

### **1. Allocation of Joint Expenses**

The allocation of joint expenses must be made on a reasonable basis which, depending on the circumstances, may include such methods as square footage allocations, allocations of percentages of employee time, and comparative usage of equipment. It is obvious that, for purposes of reducing taxation of gross unrelated business income, organizations must have in place systems to keep adequate records for computing net taxable income which will withstand scrutiny by the Internal Revenue Service.

### **2. Multiple Activities**

In circumstances where an organization operates more than one unrelated trade or business, losses from one such activity may be used to reduce profits from the other activity or activities. However, loss activities must have been conducted with a profit motive in order that they may be used to offset taxable profitable activities. Consequently, the Service will look at the past history of a particular activity to determine whether it has regularly operated at a loss. If this is the case, the Service may challenge the use of the loss as an offset to taxable income. However, even with this caveat, it is obvious that the ability to offset profits from some activities with losses from other activities may create significant opportunities for tax planning. It is also possible that deductions for net operating losses from an unrelated trade or business may be carried back or carried forward to other taxable years.

### **3. Specific Deductions**

There is also a specific overall deduction of \$1,000.00 available for organizations which do receive unrelated business income.

#### **4. Tax Rates**

All nonprofit organizations subject to tax, other than certain trusts, are taxable at corporate rates. For example, for the year 2001, the tax rate on net taxable income up to and including \$50,000.00 is fifteen percent.

Taxes are calculated and reported on IRS Form 990-T. An organization anticipating its unrelated business income tax to be more than \$500.00 must make quarterly estimated tax payments. All tax remaining should be paid when the Form 990-T is filed.

#### **D. EXCESSIVE UNRELATED BUSINESS INCOME**

Organization leaders must also be attentive to excessive unrelated business income. A large proportion of unrelated business income could indicate that the organization is not organized and operated primarily for its tax-exempt purposes. While there appears to be no hard and fast rule, many authorities believe that a safe level of gross unrelated business income is 20 to 30% of the organization's total income depending upon the specific organization and the nature of activities involved.

#### **E. ADVERTISING INCOME**

Many nonprofit organizations receive income from advertisements in their publications, such as periodicals, directories, and event programs. In addition to the rules set forth above, advertising also raises the issue of "exploitive income." This arises where the publication is an exempt function of the organization and which would be conducted regardless whether advertising was included. To deduct certain costs related to advertising may be considered to exploit the exempt purpose publishing activity. Consequently, there are special rules pertaining to allocation of overhead costs to advertising. These rules take into consideration the "circulation income" and "readership costs" of the publication. But, by being aware of these rules and obtaining advice or assistance regarding them when necessary, a nonprofit organization can take advantage of an existing opportunity for increased funding.

#### **F. AVOIDING TAXATION OF ADVERTISING INCOME**

##### **1. Related Advertising**

It can be argued that accepting advertisements for products or services related to the purposes of the organization does not constitute an unrelated activity. However, such an argument may be difficult to sustain. The United States Supreme Court in *United States v. American College of Physicians* 106 S. Ct. 1591 (1986) unanimously ruled that advertising regarding pharmaceuticals, medical supplies and equipment in a medical journal was an unrelated activity even though the publishing organization had a longstanding policy of accepting only advertisements reviewed and approved for accuracy and relevance to the practice of medicine. The organization also argued that advertising performed a valuable function for doctors by disseminating information on recent developments in drug manufacture and use. However, the Court stated that in order to be related the advertising activity had to contribute "importantly" to the organization's educational purposes. While the Court held against the organization, it did leave open the possibility that taxation could be

avoided under the right circumstances. It stated that by “coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury.”

## **2. Sponsorship Income**

Income received from “sponsorships” may or may not be considered to be taxable advertising income depending on the circumstances. Under a safe haven provided by Internal Revenue Code Section 513(i) pertaining to “qualified sponsorship payments,” it is possible that copy content in a nonprofit organization’s publication recognizing a sponsor will not be considered advertising. A statement limited simply to recognizing and/or thanking a sponsor for support usually will not be considered to be advertising. Also, a sponsor’s logo or slogan that is an established part of the sponsor’s identity may be included. However, a statement identifying a sponsor and containing a “call to action” encouraging doing business with the sponsor will be considered to be advertising. Unfortunately, this safe haven does not apply to publications which are periodicals.

## **3. Volunteer Activities**

For smaller organizations whose publications are of limited circulation, it may be possible to avoid taxable treatment by having substantially all of the advertising activities conducted by volunteers.

## **G. CONCLUSION**

Generally, leaders of nonprofit organizations should carefully consider, but not shy away from, the concept of unrelated business income. As long as an organization’s leaders understand that there will be exposure to tax on net unrelated business income and keep appropriate records to substantiate deductions from gross income, the after-tax income can still be of great assistance in meeting an organization’s cash flow needs and in furthering the organization’s mission.\*

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\* For further information on Unrelated Business Income, see Internal Revenue Service Publication 598, entitled Tax on Unrelated Business Income on Exempt Organizations.