

# UNRELATED BUSINESS INCOME TAX

The area of unrelated business income tax and the activities subject to it has been a rather confusing area over the years. Many questions, whether on unrelated business income or other legal matters, cannot be answered on a black or white, yes or no basis. These uncertainties are due to differences in the way laws are interpreted in this area. This handout will hopefully serve to guide each of you on a proper path in making a reasonable interpretation as to whether any of your parish's ancillary functions or activities may be subject to the tax.

## **PURPOSE OF THE TAX**

Taxes on unrelated business income fall into two categories:

- The unrelated business income tax
- The unrelated debt-financed income tax

The purpose of either tax is to prevent the exempt organization from having an unfair advantage when competing with taxable enterprises.

The most important factor in determining taxation is whether the activity is substantially related to the organization's exempt function. If the activity is substantially related, it is not taxed. If it is not related, a further analysis is required and will be initiated by the Finance Office. The type of activity generating the income, not the final use of the income, determines the tax effect.

## **EXEMPTION GUIDELINES**

The following is a list of possible exemptions from taxation for an activity. For an activity to be taxable it must fail all seven of the tests below:

1. Substantially all merchandise held for sale has been received as gifts or contributions.
2. Activity workers are substantially all volunteers.
3. Activity is not for the general public, but for church members.
4. Income is passive and not debt-financed.
5. Activity is substantially related to a religious purpose.
6. Activity is not regularly carried on.
7. Activity is not conducted as a trade or business.

A more detailed explanation of the exemption items is provided below:

### **EXEMPTION #1**

Does the activity consist of the sale of merchandise substantially all of which has been received as gifts or contributions?

**Guideline:** The IRS has not yet defined "substantially all," but the U.S. Catholic Conference believes 85% to be sufficient.

**Example:** Thrift shops, bake sales, rummage sales, silent auctions, etc.

### **EXEMPTION #2**

Is substantially all of the work of the activity performed by unpaid volunteers?

**Guideline:** Assuming that the 85% test is accepted by the IRS, then any activity in which 85% of the work is performed without compensation will not be subject to the tax. Compensation includes receiving anything of value such as receiving tuition credits in exchange for participation in an activity. It would seem appropriate to apply the *85% (or other applicable percentages)* test to these areas: man hours worked; number of employees; actual payroll compared with payroll if everyone is paid at the going rate.

**Example:** Any activity can qualify for this exemption. Bingo, bookstore, dances, etc.

### **EXEMPTION #3**

Is the activity carried on primarily for the convenience of the church's members, students or employees?

**Guideline:** The activity is not taxable if it is for the convenience of the members, students, or employees of the exempt organization. The activity should be done on the premises of the exempt organization.

**Example:** Student bookstore, religious bookstore, student cafeteria

### **EXEMPTION #4**

Is the income passive in nature?

**Guideline:** Most passive income (rent, interest, dividends, royalties etc.) is not taxable provided that said income is not derived from borrowed funds. The primary exceptions are rental from personal property and debt-financed income. Rental from personal property (*i.e., other than real estate*) is generally taxable income. When real and personal property are rented together, the rent attributable to the personal property is considered not taxable if it constitutes no more than an incidental amount of total rent. Rental income from real property is taxable if the amount of rent depends upon the net income derived from the rented property.

Income, including rents from real property, is debt-financed if the property which produces the income was acquired with borrowed funds and some portions of the debt remains during the taxable year in which the income is earned. Income-producing property may be found to be debt-financed even when purchased outright, if debt is incurred on a different piece of property to finance the outright purchase of the income producing property.

Debt-financed property is often used in both a related and unrelated function. If 85% or more of the use of the property is devoted to a substantially related religious function, the unrelated portion may be ignored under a de minimis rule in the regulations. (Section 1.514(b)-1(b)(1)).

In general, if your parish has property which is being rented to outside organizations and this property has debt (ex. mortgage), it is probable that it may be subject to the tax. The rules regarding debt-financed property are complex.

**Example:** Interest, dividends, gains from sale of property, rental income which is not debt financed, etc.

### **EXEMPTION #5**

Is the activity substantially related to a religious purpose?

**Guideline:** The general requirement for funds to carry out religious purposes does not provide the required relationship between the activity producing the funds and the religious purpose. The performance of the income-producing activity, rather than the income produced, must contribute importantly to the religious purpose. Also, if the activity is performed to an extent greater than reasonably necessary to achieve the religious purpose, taxable income may result from the excess activity.

**Example:** The income from a performance of religious music probably would not be taxable. The sale of religious articles in a religious bookstore will generally be substantially related to the religious purpose.

### **EXEMPTION #6**

Is the activity regularly carried on?

**Guideline:** An activity is considered to be regularly carried on if it is done with a frequency and continuity similar to comparable commercial activities of non-exempt organizations. If a non-exempt commercial organization carried on an activity on a seasonal basis, the conduct of that activity by an exempt organization during that season may constitute regular carrying on of that activity. Also, the conduct of year-round activity one day per week may constitute the regular carrying on of that activity.

**Example:** Regularly carried on activities: weekly bingo games; parking lot operating at least one day each week; the sale of Christmas trees for a period of weeks before Christmas would probably be considered regularly carried on. NOT regularly carried on: annual fundraising events such as raffles, bazaars, dances, etc. Intermittent activities such as advertising sales in a program for a musical or dramatic performance are not ordinarily considered regularly carried on, so long as the performances are discontinuous and not promoted to the same extent as commercial performances.

### **EXEMPTION #7**

Is the activity a trade or business?

**Guideline:** The activity is a trade or business if carried on for the production of income from the sale of goods or the performance of services. An activity may be trade or business although carried on within a larger complex of activities which is not a trade or business. Generally, the definition of trade or business is quite broad.

**Example:** The mailing of low-cost articles incidental to the solicitation of contributions is not a trade or business. The sale of advertising in a religious publication is a trade or business, whether the publication is sold or distributed without charge. However, a special rule provided that no taxable income results from the sale of advertising unless there is an overall profit from the publication.