Taxable and Non-Taxable Income: How to Tell the Difference

Non-profit professionals know that the term “tax-exempt organization” is a misnomer: it does not have its plain-English meaning. Tax-exempt organizations must pay income tax on some revenue streams and not on others. Distinguishing the two takes up some 40 pages in the Federal Tax Regulations. There are common types of income which many associations receive. A review of how to distinguish between taxable and tax-exempt income may help point AFP chapters in the right direction.

Congressional Reasoning

The reason for this split-level taxing system is to be fair to tax-paying businesses. For example, if business activities were not taxed, a tax-exempt museum could use its extra space to operate a drug store. It could afford to sell goods cheaper than the other drug stores in town, because it would not have to pay federal income taxes on its profit. Congress did not think it would be fair to tax-paying businesses to give tax-exempt organizations a competitive advantage in operating a regular business. Instead, Congress imposed a tax on unrelated business income.

While most tax-exempt organizations view the tax on unrelated business income as a curse, it can also be viewed as a blessing. The other choice for Congress was to prohibit tax-exempt organizations from engaging in any business activities at all. This would have greatly limited the possible activities of tax-exempts. Instead, Congress chose to specifically permit some business activity of tax-exempt organizations, but to tax it like any other for-profit business.

What is Unrelated Business Income?

It is important to remember that not all business income is subject to taxation or to limitations: only “unrelated business income”: as defined in the Internal Revenue Code. To determine whether an organization has unrelated business income, three factors must be present. The income must be:

A. from a business
B. that is regularly carried on, and
C. that is unrelated to the organizations exempt purpose

Each one of those factors will be examined separately.

A. Income from a business.

Not all income-generating activities constitute a “business.” A business is generally an activity carried on for the production of income from the sale of goods or the performance of services.

Merely asking for donations, for example, is not a business. Giving the donor goods or services in exchange for the donation is a “business.”
B. A business regularly carried on.

Even if an activity of a tax-exempt organization constitutes a “business,” the income will not be unrelated business income unless two other factors are present. One of them is that it must be an activity which is “regularly carried on.” The regulations state that activities which are carried on only “discontinuously or periodically” will not be considered regularly carried on.

This exemption is intended to permit a tax-exempt organization to engage in “one-shot” activities without being involved in an unrelated business. An activity occurring once per year, even if it occurs at the same time every year, may not considered “regularly carried on.”

C. A business unrelated to the organization’s exempt purpose.

Even if an activity constitutes a “business,” and even if it is “regularly carried on,” it will not be subject to the tax on unrelated business income if it is “substantially related” to the exempt function of the organization. The regulations explain this by stating that a “related” activity helps to cause the achievement of the exempt purpose; it must help to fulfill the exempt purpose in an important way for the activity to be “substantially related.”

Specific Activities

A. Advertising

The most common activity carried on by tax-exempt organizations which produces unrelated business income is advertising. The IRS takes the position that virtually all profit on advertising activities is taxable income. Even though lawyers for exempt organizations have argued that advertising is primarily conducted to educate members, the IRS and the courts have disagreed and have held that the primary purpose of most advertising is to produce revenue.

The exempt organization can deduct expenses against advertising, but the IRS regulations require that only direct expenses of advertising are fully deductible. Indirect expenses can only be deducted according to a complicated formula in the regulations. Form 990-T, which exempt organizations with $1,000 or more of taxable revenue must complete, will guide the exempt organization in calculating which expenses are deductible against advertising income.

B. Sponsorship

Sponsorship income is paid by corporations that want to bask in the reflected glow of exempt organizations. A corporation may become a corporate sponsor of an exempt organization and pay a fee for this privilege. The intentions of corporate sponsors are generally to garner a marketing advantage.
The IRS determined some years ago that corporate sponsorship income was more like advertising income than not, and issued an announcement stating that it would be fully subjected to federal income tax. The non-profit community lobbied hard to get this changed, and the IRS revised its position. Under current law, corporate sponsorship income is generally not taxable if the exempt organization gives the sponsor back an “acknowledgement of thanks” which can be publicized in any medium or venue. The acknowledgement of thanks can contain the sponsor’s name, logo, address, phone number and website address; it can depict the corporate sponsor’s products. It can thank the sponsor in glowing terms. What it can not do is make a quality judgment about the sponsor’s products or services or ask people to buy the sponsor’s products or services. If it does this latter activity, it must allocate a portion of the corporate sponsorship revenue to advertising income.

The IRS considers repeat acknowledgement of thanks of corporate sponsors in periodic publications, like a magazine or journal, to be closer to advertising income and not included in the safe harbor rules described above.

C. Consultants Directory

The IRS considers fees paid by consultants to advertise in a directory to be published to members to be closer to advertising income than not. It subjects the profit to consultant’s directories to federal income tax.

D. Mailing List Rental

Whether mailing list rental is subjected to federal income tax has been the subject of decades of litigation with the IRS. Non-profits have taken the position that mailing list rental constitutes a “royalty”: a fee paid for the use of intellectual property. Royalties received by exempt organizations are specifically exempt from taxation under the Internal Revenue Code. The Tax Court has generally agreed with this position in a string of cases that were decided mostly during the 1990’s.

The Internal Revenue Service continues to fight the battle. In recent audits, the IRS has permitted organizations to exempt from taxation revenue received from third-party list brokers, but required exempt organizations to pay tax on revenue received from rentals made directly to commercial companies. While the Tax Court would disagree with this position, it is useful for exempt organizations to know what the IRS might argue on audit.

E. Job Board Postings/Registries

The IRS has taken differing positions on the revenue received by non-profits from job boards and job registries. In some rulings, the Internal Revenue Service has granted tax exemption to organizations whose sole function was to run a job registry for a profession. In other situations it has said that job registries result in taxable income. A distinguishing factor seems to be who pays the fees. The IRS has stated that, when members pay the fees, the job registry looks more like a service to individual members which results in taxable income. When the employer pays the fees, the job registry looks more like a generalized service to the profession, the primary
purpose of which to promote the interests of the professional as a whole, and which does not result in taxable income.

In American Academy of Family Physicians v. U.S., 95-1 T.C.M. (CCH) P50, 240 (1995), the association ran a job registry for family physician placement. The association did not charge a fee to its members who were looking for a practice, but did charge those looking for family physicians a fee for using the service. The Tax Court found that the program was “sufficiently related to the plaintiff’s stated purpose to preclude the application of the unrelated business income tax.”

Conclusion

Whether a particular revenue stream is taxable or non-taxable can be a complex analysis based on the particular factors of the individual organization’s program. The tax professional preparing Form 990 will want to hear about the specifics of any revenue-generating program to determine whether the income should be classified as taxable or non-taxable.

Additional Resources


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