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Related or Unrelated Income—A Primer

Whether or not an organization's income is related or unrelated to their stated exempt purpose is an extraordinarily important question. Unrelated business income (UBI) is subject to corporate tax rates and will result in a filing requirement for Form 990-T (Exempt Organization Business Income Tax Return) if the gross income (gross receipts minus cost of goods sold) is $1,000 or more in a year. Additionally, certain states impose a tax on UBI. Changing even one factor in how the activity is conducted may change its taxability. With proper planning and consulting with tax advisors, exposure to UBI may be minimized.

Also, an exempt organization with more than one unrelated trade or business must identify each activity using the first two digits of the North American Industry Classification System (NAICS) code that most accurately describes the unrelated trade or business. UBI for each activity is computed separately, and losses from one activity may not be used to offset losses from other activities.

Three Conditions for an Unrelated Trade or Business

An activity is an unrelated trade or business if all three of the following conditions exist:

1. The organization is conducting a trade or business.
2. The trade or business is regularly carried on.
3. The activity is "not substantially related" to the carrying out of the organization's exempt purpose.

Certain activities are statutorily excluded (such as dividends and interest) from taxation even if they meet all three criteria. Failing to meet one or more of these requirements avoids unrelated trade or business classification for an activity.

Note: Special rules regarding unrelated business income tax apply to trusts including taxable, tax-exempt, and charitable remainder trusts.

Trade or Business

The term *trade or business* has the same meaning here as in IRC Sec. 162,

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which allows the deduction of ordinary and necessary expenses incurred in carrying on a trade or business [Reg. 1.513-1(b)]. The term includes any activity carried on with a profit motive from the sale of goods or the performance of services.

Profit motive. Nine factors are relevant in determining whether an activity is engaged in for a profit and no single factor is determinative. The factors include the—

1. manner in which the activity is carried on,
2. expertise of taxpayer and advisors,
3. time and effort expended,
4. expectation that activity assets will appreciate in value,
5. success experienced in carrying on the activity,
6. history of income or losses,
7. amount of profit earned,
8. financial status of the taxpayer, and
9. elements of personal pleasure or recreation.

An unrelated business activity that is conducted with the intent to make a profit does not stop being a business activity merely because it is not profitable for a particular year [IRC Sec. 513(c)]. However, no intent to make a profit may indicate an activity is not a trade or business. According to the Supreme Court, a profit motive is generally established by earning a profit. Therefore, unless the objective facts demonstrate a factual lack of profit motive, profit motive is generally presumed.

In the past, the IRS has frequently challenged the profit motive of an exempt organization's business activity incurring several years of losses. However, with the implementation of the Section 512(a)(6) siloing rules, a loss in a separate trade or business can no longer offset a gain in another trade or business. Consequently, continued losses with no intervening profits from a trade or business will not be utilized.

Incidental activities. Activities that are incidental to an organization's exempt function are not considered a trade or business [Reg. 1.513-1(b)]. This includes distributing low-cost items that are incidental to the solicitation of charitable contributions if the soliciting organization is described in IRC Sec. 170(c)(2) or (3).

Commerciality doctrine. The *commerciality doctrine* states that an activity carried on by an exempt organization in a manner similar to a commercial business may be considered a trade or business. The IRS generally applies the commerciality test in determining whether an organization qualifies for tax-exempt status. The test implies that an activity that could be substantially related to an organization's exempt purpose yet may become an unrelated activity if conducted in a commercial fashion.

Regularly Carried On

The trade or business must be regularly carried on to be UBI. Business activities ordinarily are regularly carried on if they have a frequency and continuity and are pursued in a manner comparable to similar commercial activities of nonexempt organizations [Reg. 1.513-1(c)(1)]. This is consistent with the UBIT's primary purpose of placing an exempt organization's business activities on the same tax basis as the endeavors of nonexempt businesses with which they compete. An exempt organization's activities are more likely to compete with those of a commercial operation if both entities offer their products or services during the same times each year. The frequency necessary for determining whether an activity is regularly carried on varies with the activity involved.

Normal time span of activities. Generally, if the activity is conducted over a substantially shorter period of time than typically conducted by for-profit companies, the activity is not considered to be regularly carried on (e.g., operating a refreshment stand during the two-week county fair). However, specific consideration should be given to the following activities:

- *Seasonal activity*. Even though an organization conducts an activity for a relatively short period of time, it will be considered an unrelated trade or business if the activity is a type normally conducted by commercial organizations only on a seasonal basis (e.g., the sale of fireworks or Christmas trees for the month prior to the holiday).
- *Activity operated one day a week*. An activity can also be regularly carried on even though conducted only one day each week throughout the year.
- *Annual or infrequent activity*. Activities conducted on an annual basis (such as a fundraising event) should not be considered regularly carried on. However, if an annual activity involves significant planning, preparation, and promotion that begins several months prior to the actual event, the activity can be considered to be regularly carried on.
- *Irregularly conducted activities*. Business activities that are only conducted intermittently throughout the year generally will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, consider an on-campus college bookstore selling textbooks and supplies to students. Since most sales to individuals other than students or faculty are to individuals visiting the campus for a reason other than to shop at the bookstore, the sales should be considered casual and not from an unrelated trade or business that is regularly carried on.
- *One-time event*. Generally, an isolated or one-time event is not considered regularly carried on. A church developed certain computer-related intellectual property rights as a by-product of conducting its religious activities and sold them to a commercial entity. The IRS ruled that although the sale was a trade or business, it was not regularly carried on,

based on the absence of prior sales and the church's representations that it had no plans for future software development or sales (Ltr. Rul. 201024069).

Unrelated to Exempt Purpose

The activity must not be substantially related to the organization's accomplishment of its exempt purposes. For an activity to be substantially related, it must have a substantial causal relationship to the achievement of an organization's exempt purposes. It cannot qualify as substantially related only because its income is needed or used to fund the organization's program services. Therefore, activities that have a significant, causal relationship to the accomplishment of exempt purposes are not UBI.

Planning Tip: Begin by considering how an activity is related to the organization's exempt purpose. Alternatively, consider if the activity can be modified so that it is related to an exempt purpose in the future. Carefully document how it relates to the exempt purpose.

Size and Extent of Activities. In determining whether activities contribute importantly to the accomplishment of an organization's exempt purpose, consider the size and scope of the activities involved in relationship to the nature and scope of the exempt function they intend to serve. If an activity is conducted on a scale larger than reasonably necessary to perform the exempt function to which it relates, the net income from the excess portion may be UBI.

Caution: If the size and scope of the unrelated business activity is substantial, the organization could jeopardize its exempt status.

Dual Usage of Assets or Facilities. An asset or facility may be used for both exempt and unrelated commercial functions. When there is dual usage, the use for exempt functions does not, by itself, convert the commercial activities into a related trade or business. The test is whether the activities contribute importantly to accomplishing the organization's exempt purpose(s).

Selling Products of an Exempt Function Activity. Income from the sale of items produced by an organization is considered related to the exempt function activity only if such items are not processed any further than necessary to complete the exempt function. By-products from an exempt activity, if sold in their original condition, generate exempt function income [Reg. 1.513-1(d)(4)(ii)]. If a product is used in a business endeavor beyond what is reasonably necessary for its disposition upon completing the exempt function, all the income from its sale is treated as unrelated.

Exploiting Exempt Function Activities Commercially. An organization's exempt function activities may produce goodwill or other intangibles that can be exploited commercially. Revenue from exploiting an organization's exempt activities is considered UBI unless the business operation itself contributes importantly to the organization's exempt purpose. It is not enough that the revenue is an outgrowth of an exempt function.

Practical Consideration:

It is important to document how an organization's existing activities are related to the exempt purpose. In addition, document on an ongoing basis, preferably in the board minutes, how any new activity is related to the exempt purpose.

Business League's Benefits to Members Result in UBI

The IRS recently released guidance in a program manager technical assistance memorandum that is contrary to a position taken 10 years earlier in Ltr. Rul. 201246039 regarding a Section 501(c)(6) business league's provision of pension and health benefits (PMTA 2022-004).

The guidance was updated to reflect a significant court case ruling from *ABA Retirement Funds* [114 AFTR 2d 2014-5368 (7th Cir. 2014)] and to reflect the IRS's position on the issue. The case considers the factors in Reg. 1.501(c)(6)-1 that define a business league as an association of persons having some common business interest, existing to promote the common interest and not to engage in a business ordinarily carried on for profit. Its activities should be directed towards the improvement of business conditions in one or more lines of business as distinguished from the performance of particular services for individual persons. An organization that is engaged in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a tax-exempt business league. The Seventh Circuit affirmed the lower court's determination that the nonprofit corporation organized to provide bar association members with tax-qualified retirement plans did not qualify under the factors provided in the regulations.

PMTA 2022-004 concluded that a business league's activity of providing pension and health benefits to its member does not further Section 501(c)(6) purposes. Providing pension and health benefits to members is unrelated to the exempt purpose and results in UBI.

AICPA TQA on Donated Pharmaceuticals and Other Items

In February 2022, the AICPA issued Technical Question and Answer (TQA) 6400.71, "Accounting by a Recipient Entity for Vaccines or Other Pharmaceuticals, Medical Supplies, or Equipment Received for Distribution to Specified Patients." The TQA provides nonauthoritative guidance about whether nongovernmental health care entities that receive vaccines or other pharmaceuticals, medical supplies, or equipment free of charge to dispense to specified patients (individual patients or categories of patients) may record a contributed nonfinancial asset at the fair value of the items.

Background

Health care entities sometimes receive pharmaceuticals or other items at no cost from resource providers to distribute to specified patients participating in various programs that provide the items to patients free of charge. Usually, the items are required to be dispensed to specific patients and at no charge to the patients. Typically, items must go to specific patients or be returned to the resource provider or destroyed.

Accounting Guidance

When a health care entity receives items free of charge from a resource provider to dispense to specified patients, the healthcare entity should first consider if the transaction is an exchange transaction, in whole or in part. If it is an exchange transaction, FASB ASC 606, *Revenue from Contracts with Customers*, applies.

If the transaction is a non-exchange transaction, nonprofit health care entities should apply the guidance in FASB ASC 958-605. For-profit health care entities should also apply FASB ASC 958-605 for transfers from nongovernmental entities and may apply FASB ASC 958-605 for transfers from governmental entities.

When applying FASB ASC 958-605, the receiving health care entity assesses whether it has variance power over the donated items and whether it is financially interrelated within the specified beneficiary.

If a recipient health care entity that is not a trustee and a specified beneficiary are financially interrelated, the health care entity should recognize a contribution received when it receives such assets.

The health care entity needs to determine if it has either unilateral power to redirect the use of the provided assets to another beneficiary or a financially interrelated relationship with the specified patient. If either exists, the health care entity is considered to be acting as a principal and should recognize revenue (if a nonprofit health care entity) or other income (if a for-profit health care entity) for the contributed nonfinancial asset it received to distribute to specified patients. If the health care entity does not meet either of the criteria, the health care entity is acting as an agent. When acting as an agent, the health care entity is permitted, but not required, to recognize these assets and the corresponding liability. If this policy is used, it needs to be applied consistently by the health care entity and disclosed in its accounting policies.

Nonprofit health care entities should consider the requirements of ASU 2020-07, *Not-for-Profit Entities (Topic 958): Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets*, if the arrangement will be recognized as a contribution. For-profit health care entities that determine the arrangement will be recognized as a grant should consider analogizing to ASU 2020-07 or ASU 2021-10, *Government Assistance (Topic 832): Disclosures by Business Entities about Government Assistance*, if the transaction is with a government.

TQA 6400.71 does not address accounting related to conditional contributions or to dispensing these items to patients.

Practical Consideration:

TQA 6400.71 is available on Checkpoint and **www.aicpa.org/resources/download/tqa-section-6400-71** for AICPA members.

FASB ASC 842 Refresher for Lessors

FASB ASU 2016-02, *Leases (Topic 842)*, is effective for most nonprofit organizations for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022, with early implementation permitted. When effective, FASB ASC 842 supersedes FASB ASC 840, *Leases*.

This article provides a refresher on FASB ASC 842 and implementation issues lessors should keep in mind as they prepare to adopt the new guidance. It's a high-level

overview only, so preparers should refer to the detailed guidance in FASB ASC 842 and related ASUs for further guidance. An article in the April 2022 edition of this newsletter focused on lessees and covers additional general information about ASU 2016-02.

The Basics

Accounting by lessors under FASB ASC 842 is not fundamentally changed from existing lease standards for sales-type, direct financing, and operating leases. Certain aspects of lessor accounting have been changed to conform with the revenue recognition model under FASB ASC 606, *Revenue from Contracts with Customers*. ASU 2016-02 eliminates accounting for leveraged leases, but existing leveraged leases are grandfathered during transition.

There are defined terms in FASB ASC 842, including the lease's commencement date, term, and what a lease payment includes, that are critical to correct application of the guidance. FASB ASC 842 retains the differences in FASB ASC 840 between operating leases and capital leases (now referred to as finance leases).

Nonprofit organizations should apply the guidance consistently to leases with similar characteristics and in similar circumstances. Related-party leases are accounted for the same as other leases.

Accounting and Reporting

Classification. A lease is classified as a sales-type lease by the lessor if it meets any of these criteria at the lease commencement date (these are the same criteria a lessee uses to determine whether a lease is classified as a finance lease):

- It transfers ownership of the underlying asset to the lessee on or before the end of the lease term.
- It gives the lessee the option to purchase the asset, and the lessee is reasonably certain to exercise the option.
- The lease term is for a major part of the underlying asset's remaining economic life.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee not already included in the lease payments equals or is greater than the asset's fair value.
- The underlying asset is so specialized that it isn't expected to have an alternative use to the lessor at the end of the lease.

A lease is classified as a direct financing lease if both criteria are met at the commencement date:

- The present value of the sum of the lease payments and any guaranteed residual value is greater than or equal to substantially all the fair value of the underlying asset
- It's probable the lessor will collect the lease payments plus any residual value guarantee.

A lease is classified as an operating lease if it is neither a sales-type lease nor a direct financing lease.

Allocating Contract Consideration. Lessors must allocate contract consideration to each separate lease and nonlease component, along with any capitalized costs (initial direct costs and deferred contract costs). The lease and nonlease components are accounted for separately, and lessors should follow the guidance in FASB ASC 606 when allocating contract consideration.

Lessors can make an accounting policy election by class of underlying asset to account for lease and nonlease components as a single component if the nonlease component would otherwise be accounted for as revenue from a customer contract and both (a) the lease component would be accounted for separately as an operating lease, and (b) the lease and nonlease components have the same pattern and timing of transfer. If the nonlease component is the predominant component, the combined component is accounted for as revenue. If it is not, the combined component is accounted for as an operating lease.

Another accounting policy election lessors can make is to exclude sales taxes collected from lessees (use, value added, and certain excise tax) from the contract consideration and from variable payments and consider them costs of the lessee. If a lessor makes this election, it must exclude all taxes within the scope of the election.

Initial Recognition. For sales-type leases, at the commencement date a lessor derecognizes the underlying asset and recognizes an asset for the net investment in the lease, measured at the present value of the sum of the lease receivable and expected guaranteed and unguaranteed amounts from the underlying assets at the end of the lease. The discount rate is the rate implicit in the lease. The lessor also recognizes any selling profit or loss and may expense initial direct costs.

For direct financing leases, at the commencement date a lessor derecognizes the underlying asset and recognizes an asset for the net investment in the lease, measured the same as for sales-type leases but reduced by any selling profit. The lessor also recognizes an expense for any selling loss. Selling profits and initial direct costs are deferred and included in the net investment in the lease.

For operating leases, a lessor does not derecognize the underlying asset at the lease commencement date but continues to account for the leased asset under applicable GAAP, including evaluating the asset for impairment when a triggering event occurs.

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Subsequent Accounting. For sales-type lease and direct financing leases, during the lease term the lessor recognizes interest income on the net investment in the lease. Any variable lease payments that are not part of the net investment in the lease are recognized as income when payments are received.

If collectability of the lease payments and any residual value guarantee is not probable at the commencement date, the asset is not derecognized. Lease payments received are reflected as a deposit liability until collectability becomes probable.

Each period, the net investment in the lease is increased for interest income at an amount that results in a constant periodic discount rate on the remaining balance of the net investment, and it is decreased by the lease payments collected. The net investment in the lease should be evaluated for impairment when a triggering event occurs, but it is not remeasured unless there is a lease modification accounted for as a separate contract. At the end of the lease, the lessor reclassifies the carrying amount of the net investment in the lease to the appropriate category based on the nature of the asset.

For operating leases, the lessor recognizes lease payments as income over the lease-term on a straight-line (or other more representative) basis and variable lease payments as income when terms are met and deferred initial direct costs as expenses over the lease term using the same basis as lease payments are recognized. If collectability of the lease payments and any residual value guarantee is not probable at the commencement date, the amount of lease income recognized is the lesser of the income that would be recognized as noted above or the lease (including variable) payments received.

Financial Statement Presentation. For sales-type and direct financing leases, the aggregate net investment in lease assets is presented separately from other assets and classified as current or noncurrent. On the statement of activities, income from leases is presented on the face of the statement of activities or disclosed in the notes, and profit or loss recognized on leases should be presented on the statement of activities. On the statement of cash flows, cash received from leases is included in operating activities.

For operating leases, lessors should apply applicable GAAP to the presentation of the underlying assets. Cash received from operating leases is included in operating activities on the statement of cash flows.

Auditing Brief

OMB COMPLIANCE SUPPLEMENT STATUS. Despite plans for an early 2022 release, we are well into May, and the Office of Management and Budget's (OMB) 2022 Compliance Supplement is not yet available. We hope that by the time you read this article, the final Compliance Supplement will be available. The latest information we've heard is that the Compliance Supplement has been cleared for release, and we should see it released by mid-May. We'll update you on the Compliance Supplement's contents when it is released. In the meantime, you can check for the new Compliance Supplement at **www.whitehouse.gov/omb/management/office-federal-financial-management/**.