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Charities Must Consider UBIT Consequences of Creative Fundraising

Related Attorneys

Victor J. Ferguson

Emily S. Pan

Suzanne R. Galyardt

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The Tax Cuts and Jobs Act (the Act) was signed into law on December 22, 2017 and made sweeping changes to many laws affecting tax-exempt organizations. One change was to double the standard deduction, which is now $24,000 for a married couple filing jointly. This change combined with the $10,000 limit on state and local tax deductions means that many taxpayers will no longer itemize deductions. This eliminates the tax incentive for many taxpayers to make charitable contributions. With anticipated declines in contributions, charities may be looking for more creative sources of fundraising to sustain their operations, such as advertising online and in publications, promoting or hosting events with for-profit companies, selling products, engaging in restaurant nights, or providing consulting or other services. While such activities raise revenue, charities need to be mindful of the rules related to the unrelated business income tax (UBIT) and the changes that were made to such rules under the Act.

Overview

Charities' revenue is generally treated as unrelated business taxable income (UBTI) if (1) it is from a trade or business, (2) the trade or business is not substantially related to the charity's exempt purposes, and (3) the trade or business is regularly carried on by the charity. There are a number of general exclusions and exceptions, including dividends, interest, certain rental income, royalties, qualified sponsorships, certain research activities, convenience activities, the sale of donated goods, and activities conducted by volunteers.

If income satisfies such requirements and does not qualify for an exclusion or exception, it is reported to the IRS on the Form 990-T and taxed at the highest corporate tax rate, even if the revenue is used for the charity's exempt purposes. If a charity has too much income subject to UBIT, it risks losing its tax-exempt status for having a substantial non-exempt purpose.

Changes Under the Act

1. Limitation on Losses

Under prior law, charities could aggregate all of their unrelated trade or business activities and net their losses from one unrelated trade or business against taxable income from another trade or business, paying tax only on the net income. For example, a charity that had taxable income from advertising but had a greater loss on hosting for-profit events would not have to pay tax. Beginning in 2018, a charity must calculate UBTI separately for each trade or business, and losses from one trade or business may not offset income from another trade or business. Using the same example, now if an organization has income from advertising and a loss from hosting events, it may not use the loss to offset the income. Net operating losses may only be used to offset taxable income from the same trade or business in future years. Net operating losses generated prior to 2018 are grandfathered, however, and may reduce UBTI from any trade or business in future years. The IRS has promised guidance regarding how to define a trade or business activity. Commentators have speculated, for example, whether the new law goes so far as to require different investments in a pooled endowment fund to be reported as separate trade or business activities.

2. Lower Corporate Tax Rates

While some charities may have increased UBTI due to the limitation on losses, this may have less of an impact because the highest corporate tax rate has decreased substantially from 35 percent to 21 percent. Thus, the “cost” of paying UBIT has gone down, which may incentivize some charities to engage in UBTI-producing activities to support the overall financial health of the charity, so long as such activities do not become substantial.

Conclusion

Some charities are feeling pressure to find creative fundraising solutions. While such activities may raise funds necessary for the operation of the charity, it is critical to consider the related UBIT consequences to ensure proper reporting to the IRS and that the charity’s tax-exempt status is preserved.