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Nonprofit Organizations' Income Tax Liability under the Unrelated Business Income Tax

ORS § 317.920
ORS § 317.930
ORS § 317.950

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INSIGHT

The income of an Oregon nonprofit corporation is generally exempt from taxation. However, certain types of income, known as Unrelated Business Taxable Income, will be subject to Unrelated Business Income Tax. Perhaps the biggest trap for the unwary is the subjugation of income derived from debt financed property owned by a nonprofit. A practitioner should be aware of this potential pitfall to avoid an unexpected tax liability for a nonprofit client.

ANALYSIS

Nonprofit organizations may incur income tax liability if it engages in certain investment strategies. Nonprofits should be particularly aware of the potential consequences involved in a part gift/part sale transaction.

Oregon imposes the Unrelated Business Income Tax in the same manner as federal law. Under federal law, the income of a nonprofit that is derived from debt financed property is taxable. This rule sounds simple, but is more complicated than it appears in its application. Of particular interest is the taxation of income that is derived from certain real property, as well as investment income where the funds invested were borrowed from another source. If a nonprofit owns real property and uses that property as collateral for a loan, then invests the liquid funds in a business venture or simply an investment account, the resultant income will be taxable to the nonprofit.

This issue comes into play quite dramatically if the nonprofit wishes to buy a piece of income producing property and partially finances it. The income stream derived from the property will be subject to Unrelated Business Income Tax because the property is leveraged. That circumstance may arise where a donor wishes to make a part gift/part sale to the nonprofit, in which case the nonprofit must come up with cash to purchase the property. If it does not have its own cash sources, it may seek outside financing to fund the purchase and must be aware of the negative result that follows when income is derived from that property after purchase. The part gift / part sale from the donor, made with the best of intentions, may result in a shock that arrives in the form of a tax bill to the nonprofit.

The simple fact that the nonprofit may owe a tax liability for the Unrelated Business Income Tax isn't the worst thing that could happen, given that the nonprofit must have an income stream to produce the taxable income. The understanding and expectation of the tax liability is valuable information a lawyer can provide to a client to avoid unanticipated tax expense for which sufficient funding hasn't been adequately planned.