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# UNRELATED BUSINESS TAXABLE INCOME

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# AGENDA

- **Introduction**
- **Current Environment for Exempt Organizations**
- **Unrelated Business Income**
  - The Basics
  - UBTI Special Topics
  - Cost Allocations
- **Current Developments**
- **Questions**

## UBTI Statistics

- **Approximately 41,000 tax-exempt organizations reported \$10.849 billion in gross UBI**
- **Nonprofit organizations reported net unrelated business income of \$780.1 million**
- **The reported UBI tax paid by approximately 20,000 exempt organizations was approximately \$541 million**

**Source: 2005 IRS Statistics**

## Impact of Financial Downturn

**IRS EO Director, Lois Lerner –**

- **Economic crisis has forced exempt organizations to use innovative fundraising practices – many organizations are turning to fundraising practices outside of their mission, often subject to UBTI.**
- **The Service usually focuses on UBTI in IRS exams.**

**April 2009 – 26<sup>th</sup> Annual “Representing and Managing Tax Exempt Organizations” in Washington D.C.**

# **IRS Compliance Initiatives 2009**

- **Hospital Questionnaire - Follow up report to include results of executive compensation exams conducted as part of the project.**
- **Community Foundations Questionnaire - IRS will follow up with design of a project to properly classify foundations and begin exam of foundations identified through compliance checks.**
- **College and University Compliance Check Questionnaire –information requested regarding unrelated business income activities.**

## IRS Compliance Initiatives

- **Disclosure to state agencies - 2008 disclosures to state agencies included:**
  - **Revocations – 16**
  - **Excise Taxes – 14**
  - **Terminations- 161**
  - **Denials – 5**
- **State Referral Program – states made 83 referrals to IRS.**

# Unrelated Business Taxable Income “UBTI”

- Even though an organization is recognized as tax exempt, it still may be liable for tax on its unrelated business taxable income.
- An exempt organization that has \$1,000 or more or gross income from an unrelated business activity must file Form 990-T.
- An organization must pay estimated tax if it expects its tax for the year to be \$500 or more.

# Challenges

## ■ Identifying UBTI –

- Is it clear that the activity constitutes a “trade or business”?** As a practical matter almost any activity entered into for profit is a “trade or business.”
  
- Is it clear that the activity is “not substantially related”?** Know your mission.



## Unrelated Business Activity

- An activity is an unrelated business if:
  1. It is a trade or business,
  2. It is regularly carried on, and
  3. It is not substantially related to furthering the exempt purpose of the organization.

## Trade or Business

- The term *trade or business* generally includes any activity carried on for the production of income from selling goods or performing services.

## Regularly Carried On

- **Business activities of an exempt organization ordinarily are considered *regularly carried on* if they show a frequency and continuity, and are pursued in a manner similar to, or comparable to, commercial activities of nonexempt organizations.**

## Substantially Related

- A business activity is *substantially related* to exempt purposes, in the statutory sense, only when the conduct of the business activities has a substantial, causal relationship to achieving exempt purposes (other than through the production of income).
- The activities that generate the income must contribute importantly to accomplishing the organization's exempt purposes in order to be substantially related.

## Fragmentation Rule

- **An activity does not lose identity as a trade of business merely because it carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.**
- **For purposes of calculating gross UBTI, an organization's operation is fragmented into component parts.**

## Exceptions to UBIT

- **Volunteer Labor**: Any trade or business is excluded in which substantially all the work is performed for the organization without compensation. Some fundraising activities may meet this exception.
- **Convenience of Members**: Any trade or business is excluded that is carried on by an organization described in section 501(c)(3) or by a governmental college or university primarily for the convenience of its members, students, patients, officers, or employees.

## Exceptions to UBIT

- **Selling Donated Merchandise**: Any trade or business is excluded that consists of selling merchandise, substantially all of which the organization received as gifts or contributions. Many thrift shop operations of exempt organizations meet this exception.
- **Thrift Shop/Donated Goods Exception**: Unrelated trade or business does not include the selling of merchandise substantially all (>85%) of which has been donated to the organization.

## Exceptions to UBIT

- **Trade Shows**: Certain trade shows and similar activities designed to promote the products or services of an industry are exempted from the scope of the UBIT.
- **Bingo Games**: Income from the conduct of certain “noncommercial” bingo games is excepted from the scope of the UBIT if specific requirements are met.



## Exceptions to UBIT

- **Rental/Exchange of Member Lists**: May qualify for exclusion depending upon the facts and circumstances.
- **Low cost articles**: Distribution of low cost articles incidental to charitable solicitations.
- **Gains and losses on sales other than inventory**: Generally such sales are excluded.

## UBTI Exclusions – Passive Income

- **Dividends, interest**
- **Royalties**
- **Rents from real property**
- **Rents from personal property which are incidental to a real property rental (less than 10% of rent value). If more than 50% of total rent is attributable to personal property, all rent is taxable.**

## **Exception to Passive Income Exclusion Unrelated Debt-Financed Income**

- **UBTI - % of income derived from debt-financed property equal to “average acquisition indebtedness” (computed on monthly basis) for year over “average amount of adjusted basis for the year” (computed on annual basis).**
- **Exception to Unrelated Debt-Financed Income rules for certain organizations (i.e., educational institutions).**

## UBTI Special Topics

- **Qualified Sponsorship Income v. Advertising**
- **Partnerships & Alternative Investments**
- **Joint Ventures**
- **Single Member LLC**
- **Income From Controlled Organizations**
- **S Corporation Stock**

## Qualified Sponsorship Income

- **Qualified sponsorship income excluded from UBTI.**
- **Qualified sponsorship income: Any income to which there is no arrangement or expectation for receiving any “substantial return benefit” other than the use of acknowledgement of name or logo. Any benefit other than use of acknowledgement of name or logo in connection with the exempt entity’s activities not permitted.**
  - ✓ **No comparative or qualitative descriptions**
  - ✓ **May display product lines/service listings**

## Qualified Sponsorship Income

- **Provision of goods or services with an insubstantial value are permitted.**
  - **Benefits such as complimentary tickets, pro-am playing spots and receptions for donors have insubstantial value only if their fair market value (FMV) is not more than 2% of the payment.**
  - **If the aggregate FMV of the benefits exceeds 2% of the payment, the entire FMV of the benefits is generally a substantial benefit.**

## **Exploited Exempt Activity Income - Advertising**

- **Income from an unrelated trade or business activity that exploits an exempt activity**
- **Expenses, depreciation and any other deductions attributable to the exploited exempt activity may be taken against the unrelated trade or business but may not generate a loss.**

## Investments in Partnerships

- ❑ **Income from partnerships carrying on an unrelated trade or business is taxable**
  
  - ❑ **Gross income and deductions determined same as if organization carried on activity directly**
    - **If partnership activity is related to exempt purpose of organization, no UBI.**
    - **If the income item would not be taxable if the exempt organization received it directly, it is not considered UBI.**
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# Alternative Investments

- **Broadly defined, asset classes and strategies other than traditional stocks and bonds**
  
- **Most common “Alternative Investments” – LPs invested in:**
  - **Real Estate**
  - **Private Equity**
  - **Hedge Funds**

## Alternative Investments

- The UBI treatment depends in part on the structure of the investment.
- Corporation – generally few consequences to the exempt organization:
  - The income is taxable to the corporation and only dividends flow through to the organization.
  - Unless the investment is debt-financed at the organization level, there should be no UBI.

## Alternative Investments

- **Partnership or LLC** – “In the case of any partnership regularly carrying on a trade or business ... the information required... to be furnished to its partners shall include such information as is necessary to enable each partner to compute its distributive share of partnership income or loss from such trade or business.”
  - Income may be in the form of dividends, interest or capital gains, which are excluded from UBI.
  - Some of these vehicles use leverage, so there can be UBI coming through as debt-financed income.

## Alternative Investments

- **Challenge – the statement attached to the Schedule K-1 typically fails to elaborate on the facts or circumstances that caused the activity to be classified as a taxable activity.**
- **Many statements provide certain percentages to be applied to various lines on the schedule K-1 without further detail.**
- **Investment may result in multi-state filing requirements.**

## Alternative Investments

- **An alternative investment may involve offshore operations resulting in UBTI, especially if the partnership is engaging in a trade or business:**
  - **The business income will flow through and will be taxable to the organization.**
  - **The investment may result in foreign reporting requirements.**
  - **Sometimes a blocker corporation is used to insulate the organization from UBI. (Challenge – getting information needed for foreign reporting requirements.)**

# Joint Ventures with For-Profit Entities

## ■ Whole Entity Joint Ventures

- Exempt organization contributes all of its assets and activities for a percentage of the profits
- The for-profit contributes cash for a percentage of the profits
- Rev. Rul. 98-15 – focus on exemption rather than UBI. Focus on control exercised by exempt organization.

# Joint Ventures with For-Profit Entities

## ■ Ancillary Joint Ventures

- Participation in a trade or business but exempt organization continues to carry out its exempt function
- Two-prong test
  - Does the activity further charitable purposes?
  - Does arrangement insulate the organization from private benefit?
- Rev. Rul. 2004-51

# Single Member Limited Liability Company

- **Disregarded entity for federal income tax purposes**
- **SMLLC activity is attributable to the member organization and subject to UBTI rules**



## **Income from Controlled Organizations**

- **The exclusions for interest, annuities, royalties, and rents may not apply to a payment of these items received by a controlling organization from its controlled organization.**
- **The payment is included in the controlling organization's unrelated business taxable income to the extent it reduced the net unrelated income (or increased the net unrelated loss) of the controlled organization.**
- **All deductions of the controlling organization directly connected with the amount included in its unrelated business taxable income are allowed.**

## **S Corporation Stock**

- **An organization that owns S corporation stock must take into account its share of the S corporation's income, deductions, or losses in figuring unrelated business taxable income, regardless of the actual source or nature of the income, deductions, and losses.**

## Deductions

- **Generally, the Code allows deductions for the direct costs incurred in earning the income, as well as a reasonable allocation of indirect costs.**
- **For some income items, such as debt-financed dividends or interest, there aren't a lot of costs – interest and investment management fees possibly.**

## **Deductions for Advertising Activity**

- **Advertising costs might include printing, postage, sales commissions or salaries, layout and other publication costs.**
- **The rules for advertising also allow some deductions for readership costs, and these can include a variety of items.**

## **Deductions for Rental Activity**

- Rental costs will include interest, depreciation, real estate taxes, maintenance and all of the other costs of operating a building.**
  - If only a portion of the building is rented, these costs can be allocated.**
  - There may also be direct rental costs, such as leasing commissions and specific maintenance on the rented space.**

## **Allocation Methods**

- **There are a number of recognized allocation methods that can be used:**
  - **Time sheets or other time methods**
  - **Square footage**
  - **Gross income**
  - **Advertising lineage**
  - **Any other reasonable and consistent method**

## Recent Developments

- **Announcement 2008-21: addresses public disclosure responsibilities of Form 990-T.**
- **IRS clarifies that three-year limitation on making annual returns available applies to Form 990-T.**

## Recent IRS Rulings

- **PLRs 200832027 and 200832028 – Community Foundation’s sale of grant making services to charitable organization held to be related business; sale of administrative and clerical services held to be UBTI.**



## Recent IRS Rulings

- **PLR 200843036 – Rental income from debt-financed property paid to tax-exempt charitable organization by related organization, both with similar exempt purposes, not taxable unrelated debt-financed income by application of substantially related use exception (IRC 512(b)(1)(A)).**

## Recent IRS Rulings

- **PLR 200852037 - Charitable organization's charitable gift annuity program will not constitute provision of commercial-type insurance.**

## Recent IRS Rulings

- **TAM 200905033 – Activities of exempt organization with respect to new methods of medical imaging in conjunction with two business corporations constituted scientific research, and income from agreement with one business corporation did not constitute UBI.**

## Recent IRS Rulings

- **PLRs 20094025, 200904037, 2009085030-31, 20090653-56 – Favorable rulings to colleges and universities that centralized the investment of endowments in a single unitrust in which each endowment and the respective college or university are provided trust units.**
- **25 similar rulings in 2008.**

## Recent IRS Rulings

- **PLR 200931064 – Sale of members’ financial management services credit life and credit disability insurance, financial services provided to another credit union and to nonmembers, and interest income from a loan to a controlled entity constituted UBTI.**
- **Similar rulings: TAMs 200709072, 200709073, 200710017, 200710019, 200717029-31, 200717033, 200717034, 200725046-57**
- **Community First Credit Union, DC Wis. 2009-2 USTC 50496 - credit union’s sale of insurance products were substantially related to its exempt purpose of encouraging thrift.**



## **Take Away - UBTI Analysis Considerations**

- **Does the activity satisfy the three-prong test?**
- **Does the fragmentation rule apply?**
- **Do any exceptions or exclusions apply?**
- **Have all direct and indirect expenses been identified?**
- **Always document the analysis.**



# Questions?

**A copy of this presentation will be available at  
[www.schneiderdowns.com/goodwill](http://www.schneiderdowns.com/goodwill)**

**Please feel free to contact us with questions.**

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