Unrelated Business Income – Beyond the Basics

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2012 IRS Work Plan

- Unrelated Business Income Compliance Initiative
  - Unrelated business income and 990-T
  - IRS focus on unrelated business activities on Form 990 but have not filed a Form 990-T
  - Development of risk models
    - Identification of organization consistently reporting gross receipts from UBI, but declare no tax due
  - Information used in connection with upcoming UBIT project

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Miscellaneous Changes

- Publication 598
  - Available at www.irs.gov/pub/irs-pdf/p598.pdf
  - Updated March 2012
  - Federal tax deposits must be made electronically
- Form 990-T Instructions 2011
  - 990-T is not required to be made available to the public if only reason for filing is a credit for small employer health insurance premiums paid

IRS, State and Local Activities

- IRS more active in audits and identification of UBI during examinations
- State and local governments are becoming more active in monitoring unrelated business activities
  - State of Montana correspondence related to K-1 issued to non-resident exempt organization
  - State of Illinois audit of unrelated business income refund claim

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Unrelated Business Income

- Purpose of UBIT
  - Impose a tax on net profits earned by an exempt organization from conducting business activities that do not further the organization's exempt purposes
- Three criteria to constitute an unrelated business
  - Trade or business;
  - Regularly carried on; and
  - Not substantially related to the organization's exempt purpose

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Exclusions from UBI

- Substantially all work is performed by volunteers
- Activity is carried on primarily for the convenience of its members, students, patients, officers, or employees – available to 501(c)(3) organizations
- Selling of merchandise, substantially all of which has been donated to the organization

Additional Exclusions from UBI

- Qualified convention/trade show activity
  - activity must be of the kind traditionally conducted at conventions, annual meetings, etc.
  - must be conducted by 501(c)(3), (4),(5) or (6) organization
  - exempt purpose of the organization (industry) must be the primary purpose of the convention
  - internet activities that are ancillary to qualified convention/trade show qualify for exemption, activities that are not sufficiently ancillary fail to qualify for the exception (Rev. Rul. 2004-112)

Additional Exclusions from UBI

- Bingo games
- Distribution of low-cost articles as incidental to a charitable solicitation program
- Rentals or exchanges of mailing lists between Section 501(c)(3) organizations and veterans' organizations
- Qualified sponsorship payments

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Modifications From UBI

- Interest
- Dividends
  - All income derived from S-corporations is subject to UBIT – includes pass-through items
- Annuities
- Royalties
  - Payments for the use of intangible assets
  - Royalties do not include payments for personal services

Add'l Modifications From UBI

- Rents
- Securities loans
- Capital gains
- Associate member dues
  - Paid to agricultural or horticulture organizations
- Qualified sponsorship payments

Qualified Sponsorship Payments (QSP)

- Payment from which the donor does not expect any substantial return benefit other than the use or acknowledgement of the sponsor’s name, logo, or products
- “Qualified sponsorship payments” are tax exempt
- Advertising revenue is generally unrelated business income

Qualified Sponsorship Payment

- Irrelevant whether the sponsored activity is related or unrelated to the orgs. exempt purpose
- Remember exploited activity rules
  - ***advertising in exempt function publication = UBI***
- Cannot be contingent upon the level of attendance at an event
- Must be allocated if the substantial return and other benefits included in the package – must first allocate FMV to substantial return benefit

Substantial Return Benefit

- Includes
  - advertising,
  - exclusive provider arrangements,
  - goods,
  - services, and
  - other privileges.

Substantial Return Benefits Exclude

- Recognizing sponsor by:
  - sponsor's name/logo
  - slogans that are part of the sponsors identity or that do not contain qualitative or comparative descriptions
  - listing of sponsor's locations, telephone #'s, or internet addresses
  - value-neutral descriptions
  - sponsor's brand or trade names and product listings
- Display or distribution of the sponsor's product by the sponsor or exempt org. at the sponsored activity
- Hyperlink on the exempt org. website to the sponsor's site – cannot contain any endorsement or promotion

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DiMinimis Exclusion

- If the value of all benefits provided to the sponsor is not more than 2% of the amount of the sponsor's payment, all benefits may be disregarded for the purposes of "substantial return benefit"

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Advertising

- Always deemed to be a substantial return benefit and taxable as UBI
- Advertising includes:
  – qualitative or comparative language
  – price information or indication of savings or value
  – endorsements
  – inducements to buy

Royalties

- Generally are not taxable if properly structured
  - Exempt organization activity must be passive vs. active in generating the income
- IRS is actively challenging the passive vs. active positioning
- May be taxable if debt-financed

Royalties

- Income from the right to use an intangible assets of the exempt organization (i.e. logo, name, mailing list, trademark, etc.)
- Generally not taxed if deemed to be passive income
- Services rendered by the exempt organization in generating the income may result in the royalty as being included in UBI

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Debt-Financed Income

- Property held to produce income and where "acquisition indebtedness" exists at any time within the previous 12 months
- Amount of UBI is in proportion to the debt associated with the property
- If activity is reported on a Schedule K-1, review UBI reporting to ensure straight-line depreciation is used

Controlled Organization [512(b)(13)]

- Payments from a controlled organization are treated as UBI to the extent they reduce the net income of the controlled organization
  - no exception exists for interest, royalties, or rents
  - rule does not apply to dividends
  - Control = ownership (by vote or value) of 50% of the stock of the organization, profit/capital interest, or beneficial interests. Constructive ownership rules apply.
  - Income is not taxed if the activity conducted by the subsidiary would be exempt if conducted by the parent

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Partnership Income

- Income from partnership carrying on an unrelated trade or business is taxable
- Pass through income and deductions retains the same form as within the partnership
  - If the partnership activity is related to the exempt purpose of the organization, income is not classified as UBI

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Additional Reporting

- Alternative investments may require additional filings
  - Foreign filings
  - Reportable transactions
- State filings

Allocation of Expenses

- IRS actively challenging expense allocations and net operating loss carryovers
- Directly connected expenses may be deducted to offset unrelated business income
  - Expenses with a proximate and primary relationship to the unrelated business activity
- Dual use expenses must be allocated using a reasonable method
  - Documentation of methodology is crucial

Questions

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