



Unrelated Business Income

Tax Exempt Update

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CliftonLarsonAllen

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- A national CPA and consulting firm
- Service areas include assurance, tax, consulting, and outsourcing
- 3,600 employees
- Offices coast to coast
- Nonprofit group serves 6,000 clients across the country



Speaker Introductions

- **Karen Gries**

Karen is a Partner with CliftonLarsonAllen. She provides tax compliance and consulting services to nonprofit organizations. She has 25 years of public accounting experience focusing on serving the needs of exempt organizations.

- **Stephen Livingston**

Stephen has over 35 years of experience as a Certified Public Accountant and also has a long history working with nonprofits. Stephen consults regularly with the firm's nonprofit clients on compliance and reporting issues as well as structuring for-profit activities.

- **Melissa Dyer**

Melissa is a manager specializing in tax services. Melissa has over 7 years of public accounting experience and her focus is serving the tax-exempt community. Her specialties include analysis, planning and reporting for unrelated business income, lobbying activities, foreign activities and alternative investments.

Learning Objectives

- At the end of this session, you will be able to:
 - Understand the definition of unrelated business income (“UBI”)
 - Know frequently used statutory exemptions and exclusions from UBI
 - Identify common sources of UBI including exploited activities, advertising revenues, rents, royalties and alternative investments
 - Understand when alternative investments may generate UBI and require additional filings.
 - Be better able to advise clients regarding UBI

General Rule

- 501(c) exempt organization may have taxable income from the operation of a business that does not further its exempt status
- Taxed at normal tax rates
 - Corporate
 - Trust

Exempt Status

- If the unrelated activity is more than an insubstantial part of its total activities, the organization's overall tax exempt status may be at jeopardy

UBI Defined

- Trade or business,
- Regularly carried on, and
- Not related to the purposes on which the organization's exempt status is based.
 - i.e. rental activity in one EO may be related, but in another classified as UBI

Trade or Business

- Generally includes any activity carried on for the production of income from the sale of goods or performance of services
- Typically competes with commercial business activities

Trade or Business?

- Examples of Trade or Business Activities:
 - Regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose its identity as a trade or business, even though the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purpose.
 - Soliciting, selling, and publishing commercial advertising is a trade or business even though the advertising is published in a exempt organization's periodical that contains editorial matter related to the organization's exempt purpose.

Regularly Carried On

- Frequency and continuity
- Pursued in manner similar to commercial activity

Regularly Carried On

- Not regularly carried on
 - sandwich stand operated two weeks at the state fair
 - fundraising activity lasting a short period of time
- Regularly carried on
 - commercial parking lot operation on Saturday all year

Regularly Carried On?

- Intermittent Activities In General
 - Manner of conduct must be compared with manner in which activities are pursued by non-exempt organizations.
 - Where activities are conducted intermittently without competitive and promotional efforts of commercial activities, they are not regularly carried on.
 - Examples:
 - ◇ Casual sales of books by a college bookstore to non-students would not be regularly carried on, BUT
 - ◇ Non-qualifying sales that are systematically and regularly promoted and not casual are regularly carried on.

Regularly Carried On?

- Infrequent Intermittent Activities
- Where the activity occurs so infrequently or for such a short period of time, they will not be considered to be regularly carried on, even if they are conducted on an annual recurrent basis
- Examples:
 - Occasional or sporadic income producing or fundraising activities
 - Conduct or an annual dance or similar fundraising event

Not Substantially Related

- To be related, a “causal relationship to the achievement of exempt purposes” must exist
- The relationship must be “substantial”
- Must “contribute importantly” to the accomplishment of the exempt purpose of the organization

Not Substantially Related?

- Not Substantially Related?
 - A business activity is not substantially related to an organization's exempt purpose if it does not contribute importantly to accomplishing that purpose.
 - Must be a causal relationship to achievement of exempt purpose, AND
 - Relationship must be a substantial one
- Example:
 - Operation of sports and fitness center is substantially related to healthcare provider's exempt purpose, but sales of items by its pro shop not used at fitness center are not.

Not Substantially Related?

- Not Substantially Related?
 - The size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they intend to serve.
 - ◇ Activities that ARE related to exempt purposes can still generate UBI if they are conducted on a larger scale than is reasonably necessary to perform an exempt function.
 - ◇ In this instance, the portion that is more than needed is considered an unrelated trade or business.
 - Example:
 - ◇ Museum café and snack bar that regularly provides food service to individuals who are not museum patrons or staff will have UBI

Exclusions from UBI

- Even where the activity is trade or business, regularly carried on AND is not substantially related to the exempt purpose of the organization, it may be statutorily excluded.
- Certain types of income are also statutorily excluded.
- What types of activities are excluded from UBI?
- What types of income are excluded from UBI?

What activities are excluded from UBI?

- Must have one of these characteristics:
 - Is not regularly carried on
 - Substantially all of the work is performed by volunteers or by the organization without compensation
 - The activity is carried on for the convenience of its members (for orgs described in 501(c)(3) or 511(a)(2)(B))
 - Substantially all of the merchandise being sold is received as gifts or contributions

What activities are excluded from UBI?

- Section 513(d) through 513(i) specifically excludes:
 - Trade Shows / Public Entertainment activities
 - Certain qualified sponsorship payments
 - Distributions of low-cost articles
 - Certain bingo games
 - Certain hospital services
 - Certain utility pole rentals

Qualified Public Entertainment Activity

- A public entertainment activity, (501(c)(3), (4), or (5)), that promotes agricultural and educational purposes, such as is traditionally conducted at fairs or expositions, including for the purpose of attracting the public to the event to promote the breeding of animals or the development of products or equipment

Qualified Convention and Trade Show

A convention, trade show, or annual meeting, (501(c)(3), (4), (5), or (6)), for the purpose of attracting persons in an industry generally (not just the organization's members) and the public to the show for the purpose of displaying industry products or to stimulate interest in, or demand for, industry products or services, or to educate persons engaged in the industry in the development of new products and services or new rules or regulations affecting the industry

Qualified Sponsorship Payment (QSP)

A payment made by a person, engaged in a trade or business, who received no substantial return or benefit other than the use of such person's trade or business name or logo in connection with the activities of the organization that receives the payment

Distribution of Low-cost Articles

- Distribution is connected with a solicitation for a charitable contribution
- Only items that bear the organization's name or logo
- Cost is within limit for a “low-cost article”

Other Excluded Activities

- Bingo Games
- Hospital Services
- Certain utility pole rentals

What **INCOME** is excluded from UBI?

- I.R.C. Section 512 specifically excludes:
 - Interest / dividends
 - Rental income
 - Mailing list rentals (between charitable orgs)
 - Royalties
 - Possibly other types of mailing list rentals
 - Gains and losses from asset dispositions
 - Research income

Helpful Tips

- We need to consider the SOURCE not the DESTINATION of the revenue. Just because the funds are devoted to the organization's charitable purposes does not deem the activity related.
- Consider whether or not the organization is PASSIVE in generating the income. Passivity is GENERALLY a sign that there is an exclusion while an organization's active participation GENERALLY is a sign that the income is taxable.

Common Source of UBI: Exploited Activity

What is exploited exempt activity?

- In certain situations, activities carried on by an organization during the performance of their exempt purpose could generate goodwill or other intangible economic benefits which are capable of being taken advantage of or otherwise exploited
- When an organization exploits such an intangible while performing their commercial activities, the earned income that does not contribute to the accomplishment of its exempt purpose is called exploited exempt activity income
- This income is deemed to be unrelated business income

Exploited Exempt Activity Continued...

Some Examples of Exploited Exempt Activity Income (§1.513-1(d)(4)(iv)):

- Advertising
- An exempt school has tennis courts used during the regular school year for educational purposes, but operates a tennis club for court and membership fees in the summertime.
- Membership list sales to business firms.
- State Chartered Credit Unions which generate income from nonmember ATM's, insurance sales, along with car buying and warranty services.

Common Source of UBI: Advertising

- The sale of advertising in an organization's exempt periodical is one of the most common forms of exploited activity.
- The sale of advertising exploits the exempt activity by using the circulation and the readership of the periodical for commercial purpose.
- Consider whether it is regularly carried on. When not regularly carried on, income may not be taxable.
- Distinguishable from Qualified Sponsorship Payments ("QSP").

Advertising vs. QSP

Qualified Sponsorship Payment – payment by a business for which there is no arrangement or expectation that the business will receive any “substantial return benefit”.

- Irrelevant whether or not the sponsored activity is related or unrelated to exempt purpose (i.e. gala or golf tournament).

Substantial Return Benefit Includes:

- Advertising
- Exclusive Provider Arrangements
- Goods
- Services
- Other Privileges

QSPs – Substantial Return Benefit cont...

- Advertising Defined
 - Qualitative or comparative language
 - Price information or indication of saving or value
 - Endorsements
 - Inducements to Buy
- Exclusivity Arrangements Defined
 - Exclusive Sponsor – QSP & NOT TAXABLE
 - ◇ Payment by Cola-Cola for the right to be the sole beverage sponsor.
 - Exclusive Provider – NOT QSP
 - ◇ Payment by Coca-Cola to have only its products and no competing beverage company products sold at the sponsored event.

QSPs – Substantial Return Benefit cont...

Substantial Return Benefit Does NOT Include:

- Recognizing Sponsor By:
 - Sponsor name/logo
 - Slogans that are part of the sponsor's 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 organization at the sponsored activity.
- Hyperlink on the exempt organization website to the sponsor's site- cannot contain any endorsement or promotion.

Common Source of UBI: Debt Financed Rental

- Rental income can be statutorily excludible from UBI.
- However, the exclusion doesn't apply if:
 - 50% or more of the total rent received/accrued is attributed to personal property leased with real property.
 - The amount of rent depends in whole or in part on the income/profits derived by any person from the leased property.
 - It is unrelated debt-finance real property.

Debt Financed Rent Continued

- In general, debt-financed property is property held to produce income (including gain from disposition) for which there is an acquisition indebtedness:
 - At any time during the tax year OR
 - During the 12 month period before the date of the property's disposal, if disposed during the year.
- Not all amounts are taxable – computation of debt-financed income uses the average acquisition indebtedness, average adjusted basis of property and gross income from debt financed property.

Average acquisition indebtedness

X

Gross income from debt-financed property

Average Adjusted Basis

Exceptions to Debt- Financed Property

- Property related to exempt purposes- if substantially all (85% or more) of the use of any property is substantially related to an organization's exempt purposes, the property is not treated as debt-financed property.
- Property used in an unrelated trade or business.
- Property used in research and certain excluded activities.
- Related exempt uses.
- Medical clinics
- Life income contracts

Debt Financed Rent Continued

Neighborhood Land Rule

- If an organization acquires real property with the intention of using the land for exempt purposes within 10 years, it will not be treated as debt-financed property if it is in the neighborhood of other property that the organization uses for exempt purposes.
- This rule applies only if the intent to demolish any existing structures and use the land for exempt purposes within 10 years is not abandoned.
- Special rules apply to religious organizations.

Debt Financed Income in General

- Note that all otherwise excludible income can become taxable if the underlying asset is debt-financed (i.e. interest, dividends, capital gains and royalties).
- Consider whether portfolio income is debt financed (i.e. margin interest).
- Debt financed assets within a hedge fund will result in UBI to the exempt-organization partner. Partner Schedule K-1 should contain appropriate details.

Common Source of UBI: Royalties

- Royalty income is statutorily excludible from UBI.
- Exclusion will not apply if the royalty arrangement is not structured correctly; exempt organization must be passive (not active) in generating the income.
- Royalties include income from the right to use an intangible asset of an exempt organization (i.e. logo, name, mailing list, trademark, etc...)
- If organization renders more than de minimis services in connection with the generation of the income, the income may be taxable trade or business.

Common Source of UBI: Alternative Investments

- Investment in partnerships – the activities conducted by the partnership flow through to the exempt organization and retain the same character to the EO partner and within the partnership.
 - Trade or business activities taxable as UBI
 - Passive income excluded from UBI
- Partnership investments often generate UBI for their exempt partners.
- Must review the entire Schedule K-1 to determine whether UBI is generated
 - Typically reported in Box 20 of the K-1, Code V.

Common Source of UBI: Alternative Investments

- Investment in S-corps – all amounts reported on Schedule K-1 are classified as unrelated business income
 - No exclusion for passive activity income
- Before entering into any partnership or s-corp investments, carefully review potential tax implications

Add'l Alternative Investments Tax Considerations

- Other Filings Associated With Alternative Investments
 - MOST states also tax UBI -- understanding nexus and apportionment are critical
 - Additional filing requirements – Forms 926, 8865, 5471, 5472, FBAR, etc. Significant for non-compliance.
- Tips
 - Be sure to understand the legal structure of the alternatives
 - Carefully review the footnotes of the K-1s for details on reporting obligations

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February 5 – 7, 2014

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- Three days of interactive discussions on topics from risk management to strategic planning
- Financial and operations executives from across the country
- Registration/Agenda Now Available:

<http://www.claconnect.com/Nonprofit/CLA-Second-Annual-National-Foundation-Conference-Overview.aspx>

Religious Organizations

- Although churches and integrated auxiliaries are not required to file a Form 990, unrelated business income tax does apply
- Common revenue from UBI
 - Advertising
 - Rental income
 - Alternative investments

Allocation of Expenses

- Identification of revenue streams is merely the first step in the UBI calculation
- Proper classification and allocation of expenses is key in minimizing tax consequences
- All direct and indirect expenses may be allocated to offset UBI
- Allocation should be made on a reasonable basis
- Documentation of the methodology for the expense allocation is crucial

General Tips

- Know and understand all sources of revenue for your nonprofit clients.
- Know and understand the legal structure of alternative investments.
- Read the footnotes and statements attached to the K-1s.
- It is the source of the revenue and NOT destination that determines whether or not it is taxable.

Questions



Melissa Dyer, Manager
melissa.dyer@claconnect.com

Karen A. Gries, Principal
karen.gries@claconnect.com

Stephen Livingston, Senior Manager
stephen.livingston@claconnect.com