Unrelated Business Income Tax

2013 Audit and Accounting Update
**Circular 230**

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Unrelated Business Income Basics

- Form 990-T is required when gross UBI > $1,000.
- UBIT is generally paid at the corporate tax rates.
- UBIT is also generally paid to the state in which the activity occurs, at the state corporate tax rate.

- Unrelated Business Income Activity broadly defined:
  - Trade or business,
  - Regularly carried on, and
  - Not substantially related to exempt purpose(s)
Learning Objectives and Agenda

At the end of this session, you will have learned about the following topics:

• Unrelated business income (UBI) basics including identification and documentation of UBI activities
• Overview of the IRS Exempt Organization Work Plan
• Emerging Topics
• How to Protect Your Organization’s Exempt Status
Identifying Unrelated Business Activities

- Start with the assumption that income is UBI.
- Determine whether the activity fails one (or more) factor(s) of the 3-part definition of an unrelated business activity.
  - Is it a “trade or business”?
  - Is it regularly carried on?
  - Is it substantially related to your organization’s exempt purpose?
- Determine whether the activity qualifies for modification, exception or exclusion.
- Reasonably and accurately measure the expenses, losses, and/or bases of the unrelated business activity.
- Document rationale, financial activity, and retain records according to IRS guidelines.
Documentation

- Appropriate documentation depends on the situation.
- Retain support for all revenues you claim are not UBI.
- Retain support for all expenses claimed as offsetting UBI.
  - Prove that the expense occurred and that it was directly connected with the unrelated activity.
- Retain at least through the statute of limitations:
  - Three years for all tax claims.
    ◊ Three years from later of due date or date filed.
  - Six years for gross understatement of income.
    ◊ Understate gross income by at least 25%.
    ◊ Does not apply to overstatement of expenses or basis.
IRS Exempt Organization’s 2012 Results

- 400 colleges & universities were sent questionnaires
- Based on responses given by organizations in the questionnaires
  - 34 were further examined by the IRS
  - IRS then concentrated on the reporting of Unrelated Business Income on the Form 990-T
- Why?
  - Each year, IRS Statistics of Income Staff find exempt organizations offset most of their UBI with deductions and only half of the organizations required to file Form 990-T actually report any tax liability
• Significant **underreporting** of Unrelated Business Taxable Income
  
  – UBTI was underreported at **90%** of organizations surveyed
  – Underreported amounts totaled over **$90 Million**
  – Underreported amounts resulted from 30 UBI activities, but the majority of adjustments resulted from only five primary types:
    
    ◊ Fitness & Recreation Centers / Sports Camps
    ◊ Advertising
    ◊ Facility Rentals
    ◊ Arenas
    ◊ Golf Courses
IRS Exempt Organization’s 2012 Results (continued)

- Healthcare UBI Activities:
  - Billing/Collection for
    - ◊ Non-Employed Physicians or
    - ◊ Unrelated Entities
  - Reference Lab
  - Retail Pharmacy
  - Sales of Medical Equipment
  - Outside Cafeteria Sales
  - Community Education Not HC Related
  - Day Care
  - Drug Testing
  - For-Profit Joint Ventures
  - Lab Referrals from Local Physicians
  - Lodging to Patient’s Family / Public
  - Mailing List Rentals
  - Management Services to Unrelated Entities
  - Catering Services

- PSG UBI Activities:
  - Advertising
    - ◊ Periodicals/Publications
    - ◊ Web banner ads
  - Exploited Activities
  - Certain Sales of Inventory
  - Short Term Real Property Rentals
  - Outside Cafeteria Sales
  - Mixed Leases
  - Debt-financed Rental/Investment
  - Alternative Investments
  - S-Corp Income/Gain or Loss on Sale
  - Charitable Gaming
  - Lodging to Students’ Family / Public
  - Mixed Royalty/Licensing Agreements
  - Management Services to Unrelated Entities
  - Catering Services
IRS Exempt Organization’s 2012 Results (continued)

- In total (of the 34 examined):
  - IRS disallowed more than $170 Million in losses & Net Operating Losses (NOLs) which could result in $60 Million in tax liability for the impacted organizations
  - Underreporting primarily stemmed from four practices:
    1. Organizations claimed losses from activities that did not qualify as a “trade or business”
    2. 60% of organizations misallocated expenses to offset UBI for specific activities
    3. 40% of organizations incorrectly treated income producing activities as exempt when they were actually unrelated
    4. More than 1/3 of organizations reported either erroneously calculated or unsubstantiated NOLs
Underreporting of UBTI – Trade or Business?

• Trade or Business?
  – Is the activity performed in a commercial manner similar to a trade or business (within meaning of §162)?
    ◊ Does it involve selling goods or performing services?
    ◊ Is it carried on for the production of income?
    ◊ Primary objective of UBI tax rules is to eliminate unfair competition by placing unrelated business activity on same basis with for profit counterparts.
  – If the organization is selling goods or services to generate income, even if it is conducting the activity within a larger group of activities related to its exempt purpose, the activity is a trade or business.
Underreporting of UBTI – Trade or Business? (continued)

- Section 162
  - “Profit Motive” required for there to be a trade or business to support an expense deduction.

- Section 183
  - General Rule: If such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed for.
    ◊ Applicable to Individuals and S Corporations, however, IRS continually references this rule when identifying UBTI.
  - “Activity Not Engaged in For Profit” defined as any activity other than one with respect to which deductions are allowable for the year under Section 162.
  - Profit motive if three (or more) of the five taxable years ending with the current tax year exceeds the allowable deductions.
Underreporting of UBTI – Trade or Business? (continued)

- ABC Hospital UBI Activities:
  1. Retail Pharmacy
     - Sells & Rents Medical Equipment to Non-Hospital Patients
     - Sales of Drugs & Other Non-Healthcare Goods to General Public
     - Profitable
  2. Reference Lab
     - Performs Lab Tests for Community Physicians w/out Access to Lab Equipment
     - Performs Drug Testing to Local Employers
     - Unprofitable
Underreporting of UBTI – Trade or Business? (continued)

**RETAIL PHARMACY**

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<td>Less Adjustments/Allowances</td>
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<td>Less Costs of Goods Sold</td>
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<td>Gross Profits</td>
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<td>Total Deductions from UBI</td>
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<td>Unrelated Business Income</td>
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**REFERENCE LAB**

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<td>Total Charges</td>
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<td>Less Adjustments/Allowances</td>
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<td>Gross Profits</td>
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<td>Total Deductions from UBI</td>
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<td>Unrelated Business Income</td>
<td>(1,029,749)</td>
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<td>Total Unrelated Business Taxable Income</td>
<td>(526,845)</td>
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Underreporting of UBTI – Allocation of Expenses

• Direct Expenses
  – In computing UBIT, exempt organizations are allowed to deduct direct expenses defined as expenses which have proximate and primary relationship to unrelated activity.

• Dual Use Expenses
  – Exempt organizations must allocate expenses between activities when used in both an exempt function activity and unrelated trade or business.
  – Per the IRS, the allocation between activities must be “reasonable” (Treas. Reg. Section 1.512(a)-1(c))

• Renssalaer Polytechnic Institute v. Commissioner
Underreporting of UBTI – Allocation of Expenses (continued)

- Rensselaer Fieldhouse
  - Dual Use: (1) Student Activities and (2) Commercial Use
  - Commercial use was treated as UBTI
  - Three types of expenses to offset UBTI
    1. Direct expenses for commercial use
    2. Variable expenses that fluctuated depending on the actual use
    3. Fixed expenses that did not vary based on the actual use

- Rensselaer’s Treatment of Expenses
  - Variable expenses allocated to each activity based on percentage of actual use
  - Fixed expenses allocated based on actual use
Underreporting of UBTI – Allocation of Expenses (continued)

- IRS Response?
  - Challenged the allocation of fixed expenses, arguing that it should be based on the proportion of time *available for use* by the commercial activity rather than actual use.

- Substantial Difference

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<td>Available Use (days)</td>
<td>300</td>
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<td>Actual Use (days)</td>
<td>200</td>
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<td>Students</td>
<td>150</td>
<td>75%</td>
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<td>Commercial</td>
<td>50</td>
<td>25%</td>
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<td>Fixed Expenses</td>
<td>$500,000</td>
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<td>Difference</td>
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Underreporting of UBTI – Exempt, Excluded or Unrelated?

- Exempt/Substantially Related
  - Based on facts and circumstances.
    ◦ Consider nature, scope and motivation for conducting the activity.
    ◦ Consider the size and extent of the activity relative to its value in accomplishing the exempt purpose
    ◦ 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
    ◦ Relationship must be a substantial one
    ◦ The need or use of funds for exempt purposes is not sufficient.
Underreporting of UBTI – Exempt, Excluded or Unrelated? (continued)

- Excluded
  - 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.
    ◊ Passive income (interest/dividends, royalties, list rentals)
    ◊ Gains/losses from asset dispositions
    ◊ Qualified sponsorship, trade show activities
    ◊ Certain real property rental
    ◊ Specific exclusions for certain types of activities such as bingo, distribution of low cost articles, pole rentals, hospital services meeting specific requirements
    ◊ Volunteer labor exception
Underreporting of UBTI – Exempt, Excluded or Unrelated? (continued)

- Unrelated
  - Revenue activities which meet all three prongs of the UBI test and do not fall under the Exempt/Substantially Related or Excluded provisions
  - Exploited exempt activity
  - Advertising
  - Debt-financed rental
  - Royalty arrangements with more than de minimis services
  - Goods/services provided outside of the charitable class
  - Alternative investments
Underreporting of UBTI – Exempt, Excluded or Unrelated? (continued)

Advertising/Exploited Activity Examples:

- Web advertising
- Ad sales in a periodical or occasional publication
- Sale of items produced in exempt function that are altered prior to sale
- Use of organization staff/assets/intangibles for non-exempt purpose
- Services provided with lease
- Sales/services provided outside of the charitable class
Underreporting of UBTI – Debt-financed Rental Activity

- 1969 tax reform to eliminate sale-leaseback transactions between exempt organizations and other taxable entities/individuals
- Special considerations are required if the debt-financing is sourced from tax-exempt bond issues and the property financed by the bond has rental, private business use or other unrelated business activities generated
Underreporting of UBTI – Debt-financed Rental Activity (continued)

Debt-financed Rental Activity Examples:
• One of the more complex areas of UBI
• Community center owned by charity; considered to be substantially related
• Churches in compliance with the neighborhood land rule
• Museum space for rented collections; considered to be substantially related
• Certain forms of investment income that are financed
IRS Exempt Organization’s 2013 Work Plan

- In 2013, the focus will be on organizations with substantial gross UBI for three consecutive years, but reporting no tax income tax due any of those years.
- This year’s review will evaluate whether the organizations are accurately reporting their sources of UBI and correctly allocating and deducting expenses associated with it.
Protecting Your Organization’s Exempt Status

• UBI monitoring is one component of maintaining and protecting your organization’s exempt status – tax planning is key
• Public charities receive their exempt status upon the basis that they are organized and operated *exclusively* for exempt purposes as specified in IRC Section 501(c)(3)
• The IRS and case law have explicitly rejected any provision, calculation or ratio of “insubstantial” UBI and reserves the right to evaluate each case on the unique facts and circumstances of each organization
Resources

- IRS Stay Exempt

- IRS Publication 598 – Tax on Unrelated Business Income of Exempt Organizations

- 2012 Form 990-T Instructions

- IRS EO Updates: e-News for Charities and Non-Profits
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