

Unrelated Business Income: Traps, Types, Effective Uses

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South Carolina
Tax
Team



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TCJA Changes

Organizations Subject to UBIT

- ✓ Organizations subject to the unrelated business income tax generally include:
- ✓ Organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts);
- ✓ Qualified pension, profit-sharing, and stock bonus plans described in section 401(a); and
- ✓ Certain State colleges and universities.



Calculation of UBTI Activities

- ✓ For a charity with more than one unrelated trade or business, the TCJA 2017 requires that UBTI first be computed separately with respect to each trade or business and without regard to the specific deduction (the lower of \$1,000 or the gross income derived from any unrelated trade or business regularly carried on by such unit (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under §512(b)(12))



Cost Accounting Principles

- ✓ Related Trade or Business (aka “Program Service Revenue”)
 - May be more than one
- ✓ Unrelated Trade or Business (UBTI)
 - May be more than one
- ✓ Fundraising
- ✓ Administration



Find Appropriate “Carrier”

- ✓ Occupancy costs based on square feet
 - Adjusted for relative value (office vs storage)
- ✓ Administrative costs based on time spent
 - Perhaps on # of transactions ? E.g. payroll
- ✓ Overhead, based on combination (?)
- ✓ Remember 85/15 rule



Excise Tax on Excess Tax-Exempt Organization Executive Compensation

- ✓ Tax-exempt organization is subject to a 20% excise tax on compensation in excess of \$1 million paid to any of its five highest paid employees
- ✓ Excise tax applies to all remuneration paid to a covered person for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash, except for payments to a tax-qualified retirement plan and amounts that are excludable from the executive's gross income



Excise Tax on Excess Tax-Exempt Organization Executive Compensation

- ✓ Under the Act, an employer is liable for an excise tax equal to 20% of the sum of:
 1. Any remuneration (other than an excess parachute payment) in excess of \$1 million paid to a covered employee by an applicable tax-exempt organization for a taxable year, and
 2. Any excess parachute payment (under a new definition for this purpose that relates solely to separation pay) paid by the applicable tax-exempt organization to a covered employee

Excise Tax on Excess Tax-Exempt Organization Executive Compensation

- ✓ An “applicable tax-exempt organization” is an organization exempt from tax under §501(a), an exempt farmers’ cooperative, a Federal, State or local governmental entity with excludable income or a political organization



Change to the Excise Tax Imposed on Investment Income of Private Foundations

- ✓ The current 1% or 2% excise tax on private foundation net investment income would be fixed at 1.4%



Unrelated Business Income

A few examples and Discussion Points



Unrelated Business Taxable Income

- IRC Sec. 512 . . . Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business

Unrelated Business Taxable Income

- ✓ IRC Sec. 513 . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . Except > > > > >



Trade or Business ? ? ?

- Regularly carried on
- Similar to for profit businesses
- Profit motive
- Debt financed
- Volunteer labor
- Donated goods

Unrelated ? ? ?

- Electricians Union runs a weekly shooting contest, charging entry fees and awarding prizes ?
- Church of Effervescent Salvation operates a Christian Bookstore ?
- Carpenters Union builds an office building and leases space to the general public ?
 - Leases space only to other trade unions ?
- Plumbers and Pipefitters builds an office building for the Union's welfare and benefit plans



Regularly Carried On ? ? ?

- 6 days per week ?
- 1 day per week ?
- 1 week each month ?
- 1 week each year ?
- Occasionally . . . Once every 4 years



Unrelated Business Taxable Income

✓ Exceptions

- Substantially all the work is performed by volunteers
- In the case of a 501(c)(3) organization or a college or university described in IRC Sec. 511(a)(2)(B), or a local association of employees, selling books, supplies, work related clothing and other items for the convenience of its members, students, patients, officers or employees



Unrelated Business Taxable Income

✓ Exceptions (Continued)

- Selling merchandise, substantially all of which has been donated to the organization
- "Substantially all" for this purpose, has been defined as "at least 85%"



Annual Event

✓ LTR 201251019; 12/12/2012

- A 501(c)(3) exempt organization's annual event to promote literacy is not considered an unrelated trade or business by reason of section 513(a)(1) and, thus, revenue from the sale of tickets to the event does not constitute unrelated business taxable income under section 512(a)(1).
- One of stated purposes was "to educate, promote, encourage, and aid children and adults everywhere in the appreciation of reading and literacy."



Excess Business Holdings

✓ LTR 201323029; 3/12/2013

- A private foundation's acquisition of stock from a corporation that supports the foundation's work does not constitute excess business holdings and compensation received from the corporation will not be unrelated business taxable income
 - Corporation's purpose and assets are compatible with that of foundation and corporate property will be used in carrying on "functionally related business"
 - As such, property will not be subject to "minimum investment return" rule of IRC Sec. 4942(e)



Self-Dealing

✓ LTR 201321027; 5/24/2013

- Execution, delivery, and performance of a settlement agreement that will affect bequests to a private foundation and involve the purchase of all the interests in a limited partnership will not constitute self-dealing
 - Same two persons are executors of estate that owned limited partnership interests and trustees of the private foundation that will benefit from sale of those interests
 - Children of decedent and trustees engaged in protracted litigation
 - All parties were represented by counsel
 - Court approved settlement
 - Self-dealing cannot be present where all are well informed



Set-Aside Program

✓ LTR 201321028; 5/24/2013

- Private operating foundation will not be subject to tax or risk loss of its status if it makes “qualifying distributions”
- Set-asides may be treated as qualifying distributions with IRS approval if project funding is best accomplished
- IRS approved an organization's set-aside funding program for restoration of a historic building that will be dedicated entirely to the organization's exempt purposes when the work is finished, saying the project can better be accomplished using a set-aside than by making an immediate payment



Unrelated Trade or Business

✓ TAM 201320023; 5/17/2013

- IRS concluded that entity's sale of life insurance policies to nonmember widows of deceased insured members, under which the widow can name a beneficiary other than a dependent of the member, isn't substantially related to the entity's exempt fraternal purposes
 - IRC Sec. 501(c)(8) only permits a fraternal benefit society to provide benefits to its members and their dependents
 - Policies offered to widows had no restrictive terms and were no different than policies offered by commercial insurers
 - Income from sale of policies is UBTI



Tax Treatment of Single Member LLC

✓ INFO 2013-0006; 3/29/2013

- IRS provided general information on tax treatment of LLCs, including an LLC that has as its sole owner an organization that is exempt from tax under section 501(a)
 - LLC owned by an exempt organization is treated as a component part of the exempt organization unless it elects to be regarded separately by filing Form 8832 and electing association status
 - An exception applies to employment taxes which must be separately reported in any event, and the LLC must secure its own EIN #



Exempt Entities Codes

✓ INFO 2013-0005; 3/29/2013

- IRS explained that the National Taxonomy of Exempt Entities code assigned to an exempt organization to characterize the organization in terms of its primary exempt activity is not relevant to any determination under the internal revenue laws or to tax-exempt status
 - NTEE Code is a 3 or 4 –character code has been issued to characterize the organization in terms of its primary exempt activity and involves exercise of judgment by IRS employees
 - Because the NTEE code is not relevant to any determination under the internal revenue laws or to tax-exempt status, organizations cannot request a change in their code as shown in the Exempt Organizations Business Master File (EOBMF)



Lobbying

✓ INFO 2013-0002; 3/29/2013

- IRS explains rules applicable to section 501(c)(3) charities that engage in lobbying activities and provides information on how a taxpayer may submit information to the IRS about an exempt organization that raises questions about its continued exempt status or compliance with tax law
- If you suspect a 501(c)(3) organization is engaged in excessive lobbying, send your information to:
 - IRS -- EO Classification
1100 Commerce Street
MC 4910 DAL
Dallas, TX 75242



Federal Credit Unions

- ✓ Community First Credit Union; ED WI, No. 1:08-cv-00057, 5/15/2009
 - A Wisconsin jury, in a trial conducted in the U.S. District Court, has found that the sale of life, disability, and automobile insurance was “substantially related” to a federal credit union’s tax exempt purpose. That’s a blow to an IRS audit initiative that was routinely classifying such income as Unrelated Business Income and assessing federal income tax on otherwise exempt federal credit unions.

Colleges and Universities (1 of 2)

- ✓ Tax Notes Today; 5/8/2013; reporting speech by Lois Lerner
 - A significant number of the colleges and universities examined as part of an IRS compliance project had more unrelated business taxable income than they reported, principally from:
 - Fitness, recreation centers, and sports camps;
 - Advertising;
 - Facility rentals;
 - Arenas; and
 - Golf courses



Colleges and Universities (2 of 2)

- ✓ Tax Notes Today; 5/8/2013; reporting speech by Lois Lerner
 - Problems were also observed with respect to compensation paid to university officials
 - Failure to test against comparables
 - Failure to include “fringe benefits” in reported value of compensation of highest university officials
 - That could result in penalties under IRC Sec. 4958, that imposes taxes on excess benefit transactions
 - 25% of the excess benefit on the disqualified person, 10% on any manager who approved it



Liquidation of Subsidiary Into Country Club

✓ LTR 201315030; 4/12/2013

- IRS ruled that a country club's 501(c)(7) status will not be affected when its subsidiary is liquidated into the club because there will be no recognition of gain or loss when the club receives the subsidiary's assets and liabilities
- Subchapter C rules apply
 - Sec. 332 - No gain or loss to parent
 - Sec. 337(a) and 336(d)(3) – No gain or loss to subsidiary
 - Sec. 334(b)(1) – Parent has carryover basis
 - Sec. 1223(2) – Holding period carries over
 - Tax exempt status will not be affected



Charitable Trust Liquidating Asset

✓ LTR 201306023; 2/8/2013

- IRS ruled that where a charitable trust is treated as a private operating foundation, its tax-exempt status will not be adversely affected when it sells interests in condominium property and those sales will not generate unrelated business taxable income
 - Property is land on which condos were constructed by developer
 - Trust owns over 6,000 acres of land inherited in 1917
 - Trustees have been advised to diversify assets
 - Trust has made no improvements related to its interest in the land
 - Sale to condo association and condo owners will not generate UBTI



Conservation Easement

✓ LTR 201302043; 1/11/2013

- IRS ruled that a social and recreational club's 501(c)(7) status will not be jeopardized by the sale of a conservation easement and that the easement constitutes property used directly in the performance of the club's exempt function, so proceeds are not taxable if reinvested
 - City department of environmental protection wanted easement on part of golf course to protect watershed leading to reservoir
 - Club will use proceeds to make improvements to various areas of the club and has documented plans for Proposed capital projects
 - IRC Sec. 512(a)(3)(d) protects gain from taxation



Clinical Database

✓ LTR 201250025; 12/14/2012

- Facilitation of a clinical database by a 501(c)(3) organization formed to operate a regional health information exchange furthers the organization's charitable purpose under section 501(c)(3) and income received in connection with facilitating the database will not constitute unrelated business taxable income
 - Database was created by collaboration between organization and major health plans and health care providers
 - Health plans pay a fee to organization to participate by both sharing and accessing data
 - Physicians receive fee for submitting data



Neighborhood Land Use Rule

✓ LTR 201246040; 11/16/2012

- Property acquired by a church will be used for an exempt purpose and will be exempt from debt-financed property provisions of the code for 15 years.
 - Neighborhood land use rule [IRC Sec. 514(b)(3)] applies
 - Church convinced IRS it is “reasonably certain” that land will be used by the church for an exempt purpose within 15 years from its acquisition, so it is exempt from the debt-financed property rule that would make rental income UBTI



Oil and Gas Lease

✓ INFO 2012-0023; 5/1/2012

- IRS provides information on whether a section 501(c)(3) tax-exempt organization risks losing its exemption because of an oil and gas lease and whether royalties received under the lease are taxable
 - 501(c)(3) organization does not pay tax on investment income
 - Oil and Gas lease bonus is rental (investment) income
 - Oil and Gas Royalty is investment income
 - Oil and Gas working interest would produce UBTI

Estimated Payments of UBIT

✓ Form 990-W

- 3 ½ pages of Form
- 3 ½ pages of instructions
- Unrelated Business Income Tax must be paid in quarterly installments
 - Annualized Income Installment Method is available
 - Adjusted Seasonal Installment Method is available



Thank You

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