Unrelated Business Income Tax

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UBI Presentation
Major Topics to be Covered

• Brief History & Overview
• Testing for UBIT
• 3 Prong Test
• Statutory Modifications (Exceptions)
• Specific Examples
• Questions
Principles of UBI

• Always remember - it’s not how you spend your money, it’s how you earn it
Basic Principles of UBIT
The Pre 1950 Law

DESTINATION OF THE INCOME TEST

- Statute said nothing about the source of the income-only the destination and use.
- “Organized and operated” test
Principles of UBIT
The Revenue Act of 1950

• Replaced the “destination of income test” with today’s statutory scheme
• Created IRC sections 511 thru 514
• Critics complained loudly that the statutes and related Treasury Regulations were extremely complicated and had a chilling effect on charitable entities
Principles of UBIT

Who is subject to UBI?

– All organizations under 501(c) other than those described under 501(c)1 (Tax Reform Act of 1969) (U.S. Instrumentalities)

– Colleges and universities that are instrumentalities of any government (federal or state) and their wholly owned subsidiaries are subject to UBIT
Principles of UBIT

• 3 Prong Test

1. A trade or business
2. Which is regularly carried on and
3. Which is not in furtherance of the purpose for which the entity was granted exemption
Principles of UBIT

• Worth Repeating

• MUST have all 3 attributes or is not UBIT
Principles of UBIT

What is a “Trade or Business?”

(1) A “trade or business” is any activity carried on for the production of income from the sale of goods or performance of services

(2) Core requirement is that there must be a “Profit motive requirement”
Principles of UBIT

– Just because an activity entered into with a profit motive fails to result in profit for any particular period does not preclude the activity from being considered a “trade or business”.

– However, the “profit motive” requirement is sometimes applied to disallow net operating loss carryovers.
Principles of UBIT

(2) What is meant by “regularly carried on?”

– Activities conducted over a period of a few weeks when otherwise conducted year-round are likely NOT regularly carried on

– The activity must be regularly carried on rather than sporadic or infrequent

– Intermittent activities not conducted in competitive and promotional manner (i.e., casual sale of real estate)
Principles of UBIT

– Frequency, continuity and size of sales is very important

– Most activities that are pursued similarly to commercial entities will be “regularly carried on”

– Activities normally undertaken by commercial entities only on a seasonal basis conducted by an exempt organization for a significant portion of the normal season may be “regularly carried on”
Principles of UBIT

• Activities intermittently conducted on a year-round basis may be considered “regularly carried on”

• Advertising in event programs will likely be “regularly carried on” if there is a substantial, regular solicitation of advertising for an extended period of time each year - NCAA case

• Activities that are usually not regularly carried on are typically special events of some sort
(3) How does one define “substantially related?”

– Business activities must *contribute importantly* to the accomplishment of a purpose for which the organization is granted exemption

– The mere production of income for use in an exempt activity is not enough – remember, that was the old “destination of income test”
Principles of UBIT

Statutory Exemptions from “trade or Business”

1. “Volunteer labor”: Trade or business in which substantially all (85%) the work is performed without compensation (the IRS construes compensation broadly)

2. Donated Merchandise: Selling of merchandise, substantially all (85%) of which has been donated

3. Convenience exception – e.g., student store
Statutory Modifications

• Most common statutory modifications under Section 512(b)
  – Dividends
  – Interest
  – Annuities
  – Royalties
  – Rents
Statutory Modifications

– Royalties – those in which the exempt organization receives payments for the use of a valuable intangible right

– Examples include trademarks, trade names, service marks, and copyrights

– Payments to the exempt organization can be based on a flat fee or based on usage
Statutory Modifications

• The IRS will generally NOT treat a payment based on a percentage of the net income as a “royalty”

• IRS contends that royalties must be from a “passive” source

• IRS further contends that that if a payment is attributable in any way to the services of, or participation by, the tax-exempt organization, it cannot be a royalty
Statutory Modifications

What is “rent from real property?”

When the amount of rent is determined by any person’s net income, e.g., shopping center

When there is substantial personal property

• <10% = all real property
• 10%-50%, prorate between personal and real
• >50%, real estate exclusion doesn’t apply
Statutory Modifications

• Rents from real property - that are not debt financed (but see special rule for colleges & universities – IRC § 514(c)(9)

– **When the Rent Exclusion Doesn’t Apply**
  • When substantial services are provided, e.g.
  • Parking garage
  • Hotel
  • Concerts
  • Conventions
Statutory Modifications

• The Issue With “Rent”
• Is it really just rent?
• Rent dependent on net income or profits?
• The “services” issue
  • More than incidental?
  • Customary & usual in a landlord/tenant context? Heat, light trash pick-up.
• What about things like security?
• Bifurcate contract?
Statutory Modifications

• Debt Financed Property (Section 514)
• But see 514(c)(9) exception for a “qualified organization”
• Exception applies to real property acquired by a “qualified organization”
• an organization (that is you) described in section 170(b)(1)(A)(ii) and its affiliated support organizations described in section 509(a)(3)
Statutory Modifications

- 514(c)(9) exceptions to the exception:
  - Property must have been acquired for a fixed amount
  - Amount of debt & timing of payment cannot be dependent on a % of revenue, income or profits from the property
  - No sale/leaseback permitted
  - Special Trust rules
  - No seller financing
  - Special partnership rules
Identifying UBIT Activities

• Budget Squeeze will result in creative campuses looking for alternate funding sources = always think possible UBIT

• Campus finance & tax people should think like an IRS Agent

• Ordinarily the agent will begin with the audited financial statements and drill down

• Will conduct a detailed review of revenue accounts, e.g.,
  – Auxiliary enterprises (including athletics)
  – Academic sales and services
  – Research Activities
  – Detailed review of balance sheet
Identifying UBIT Activities

Carefully document

- Expenses allocated to UBIT items – direct & indirect
- Loss carryovers, accounting methods, etc.
- On which accounts (out of thousands and thousands) should I spend my time?
- Which would (or should) an agent find interesting?
- Which would (or should) an agent likely ignore?
Identifying UBIT Activities

- Interesting investments (e.g., partnerships)
- Debt structure
- Interesting facilities (e.g., conference center)
- Review underlying contracts and other documents
- Interview personnel
- Read student newspapers, alumni magazines, etc.
- You likely have access to and talk to people from all over the campus regularly
Expense Allocations

Generally 3 types of expenses

• Type 1: Expenses solely attributable to business activities
• Type 2: Dual use property or project expenses
• Type 3: Exploited activity expenses
Expense Allocations

Type 1:

• Expenses solely attributable to the UBI activity are fully deductible – Reg. § 1.512(a)-1

• Must be reasonably allocable under good accounting theory consistently applied
Expense Allocations

Two classic business expense deduction concepts:

1. “Proximate and primary” relationship between the expense and the activity – typically direct expenses

2. “But for” test – would the expense be incurred if the UBI activity were not carried on?
Expense Allocations

Type 2:

• Shared employees, facilities, equipment and other overhead expenses

• Must be allocated between exempt and UBI activities on a *reasonable basis*

• The allocation methodology must be consistently applied – Reg. § 1.512(a)-1(c)
Expense Allocations

Type 3:

- Exploited activities – advertising activities are the classic example
- Certain exempt activity expenses can be used against the UBI activity but with overall limitations
Expense Allocations

• UBI code sections do not specifically address how a dual use or exploited expense is to be allocated

• Internal Revenue Manual – Exempt Organizations Examination Guidelines Handbook states that “any reasonable method resulting in identifying a relationship of the expenses to revenue produced is acceptable.”
Expense Allocations

IRS favored methodology

- **Direct gross-up method** – e.g., total salaries + 175% for indirect costs
- **Ratio method** – total costs and allocate them based on number of hours personnel spent on various functions
Expense Allocations

Summary...

• Proximate and primary relationship
• Reasonable
• Burden of proof on taxpayer
• Once adopted, method must be used consistently
• Method must clearly reflect income
Selected Specific Activities

- School Newspaper or Program Advertising
- Affinity Cards
- Corporate Sponsorships
- Entertainment & Performing Arts Events
- Exclusivity Agreements
- Mailing List Rentals
- Rentals & Use of Facilities
- Summer Sports Camps
- Athletic Events
- Fundraising Activities
- Membership Dues
- Child Care
- Parking Lots
- Conference Meetings & Training Programs
- Relief of Government Burden
Advertising activities

• The term “advertising” is defined in neither the IRC nor Treasury Regulations

• Classic example of “exploitation income”

• Exploits the EO’s circulation and readership base

• Need to isolate 4 accounting items
  1. Gross advertising income
  2. Direct advertising costs
  3. Circulation income
  4. Readership costs
Advertising activities

• If gross advertising revenue > direct advertising costs
  1. Can use excess of readership costs over circulation income as additional deduction against advertising income
  2. If use step 1 above, resulting loss cannot be used to offset UBTI from any other activity
  3. Loss also not eligible for loss carryback or carryover with respect to such advertising activity
Advertising activities

• If direct advertising costs > gross advertising income
  – Loss can be used against any other UBI activity
  – Eligible for NOL carryback or carryover
Allocation of member receipts

• Treasury Regulations provide 3 methods for determining the portion of membership dues that constitute a part of allocable membership receipts

1. If 20 percent or more of the total circulation of the periodical is comprised of sales to non members, the subscription price charged to the non member is the amount from each member’s dues to circulation income
2. If the above does not apply, and if the membership dues from 20 percent or more of the members of the organization are less than the dues received from the remaining members (because the former members do not receive the periodical), the amount of the reduction in dues is the amount used in allocating membership dues to the periodical’s circulation income.
3. If neither of the cases above apply, the share of membership receipts allocated to the circulation income is an amount equal to the organization’s membership receipts multiplied by a fraction, with the numerator equal to the periodical’s total costs, and the denominator equal to these costs plus the other costs of the exempt activities of the organization.

As an example, assuming the two methods above do not apply, if the total publication costs are $60,000 and other exempt activity costs are $100,000, and membership receipts are $50,000, $18,750 is the amount allocable to the circulation income ($50,000 x $60,000/$160,000).
Affinity Card Programs

Why do Universities use affinity cards?

- Keeps alumni aware of their ties to the University
- Keeps University’s name before the public
- Provides low-cost credit card to alumni and supporters – feels like a “fringe benefit”
- Let’s be real – PROVIDES SIGNIFICANT REVENUE
Affinity Card Programs

• Fortunately we are in the Ninth Circuit

• Famous Sierra Club and Oregon Alumni cases
  – IRS tried to argue SC was not passive but actively involved in the credit card program
  – IRS claimed was a joint venture and the “royalty” was really a distribution of the joint venture profits
  – IRS claimed SC was in the credit card business itself with the bank acting as its agent
Affinity Card Programs

• IRS relatively quiet in this area recently and unlikely to attempt to create conflict in the circuits

• Lesson clearly learned is that an affinity agreement should provide that the EO will provide little more than their mailing lists and endorsements
Corporate Sponsorships

• “Qualified sponsorship payments” received by an EO are not UBI

• Must be “no substantial return benefit” to the sponsor

• Use or acknowledgement of the sponsor’s name or logo (or product lines) is ok

• Can have no statements of quality or comparisons, price information or other indications of savings or value or an endorsement by the EO
Corporate Sponsorships

• A list of the sponsor's locations, telephone numbers, or Internet address; value-neutral descriptions, including displays or visual depictions, of the sponsor's product-line or services; and the sponsor's brand or trade names and product or service listings are OK

• Logos or slogans that are an established part of a sponsor's identity are not considered to contain qualitative or comparative descriptions and are OK
Corporate Sponsorships

• Mere display or distribution, for free or not, of a sponsor's product by the sponsor or the exempt organization to the general public at the sponsored activity is not considered an inducement to purchase or use the sponsor's product and is ok

• Cannot have to “call to action” directed to the reader or listener
Corporate Sponsorships

U's activities constitute acknowledgment of the sponsorship. The drinks, refreshments and prizes provided by the corporation are a qualified sponsorship payment, which is not income from an unrelated trade or business.
Corporate Sponsorships

• Return benefits to the sponsor are disregarded if the aggregate FMV are 2% or less than the sponsor’s payment

• Remember – a substantial return benefit may still be exempt from UBIT on some basis other than the sponsorship rules – e.g., a royalty
Corporate Sponsorships

R's use of the manufacturer's name in the writing competition constitutes acknowledgment of the sponsorship.

However, the exclusive provider arrangement is a substantial return benefit. Only that portion of the payment, if any, that R can demonstrate exceeds the fair market value of the exclusive provider arrangement is a qualified sponsorship payment.
Entertainment Events

• Entertainment events conducted by the colleges’ own students are related even if substantial portion of revenue and audience comes from the general public. (E.g., ballets, concert recitals, plays) (Treas. Reg. 1.513-1(d)(4)

• IRS does not look at the “cultural” aspect so much as the fact that it is a professional performance involving paid entertainers

• Professional entertainers; related only if they are “operated primarily as an integral part of the educational program of the university – almost impossible standard to meet (TAM 9147008 and GCM 39,863)
Entertainment Events

• Unrelated if “operated in substantially the same manner as a commercial operation”

• IRS “unrelated” factors:
  – Fees charged are comparable to those charged by commercial facilities
  – Only those who purchase the goods or services benefit from the activity
  – Organization furnishes facilities and conducts activities with its own employees who perform substantial services in conducting the event (security, concessions, janitorial, promotions, etc.)
  – The organization’s reputation as an educational institution is secondary, if a factor at all, in attracting attendees
  – Predominant motivation is revenue maximization
Exclusivity Contracts

• Has been a very hot issue since the early 1990s

• “Exclusivity (pouring rights) agreements are still a hot issue – despite the recent Treasury Regulations adopted in April of 2002

• Only the amount of any sponsorship payments in excess of the value of returned benefits (if any) constitutes excludable income to the EO
Exclusivity Contracts

• Must value the exclusivity rights in determining the amount of the sponsorship payments that must be treated as potentially subject to UBI

• Best to stipulate such amount in the contract with the sponsor and support its FMV
Exclusivity Contracts

• Recent internal memorandum by Thomas Miller, the Acting Director of IRS EO Rulings and Agreements

• “...although the income from some exclusive provider arrangements may be includible in UBTI, not all contracts will meet the criteria for inclusion in UBTI pursuant to sections 511, 512 and 513.”

• Now support for the proposition that if the arrangement is not a qualified sponsorship payment, it is analyzed under the standard UBIT principles and rules and not “per se” UBTI
Exclusivity Contracts

A University that enters into a multi-year contract with a soft drink company to be the exclusive provider of soft drinks on campus in return for an annual payment is not necessarily subject to UBIT on that payment. If the company agrees to provide, stock, and maintain on-campus vending machines as needed, leaving little or no obligation on the University’s part to perform any services or conduct activities in connection with the enterprise, then based on this contract alone the University may not have the requisite level of activity to constitute a trade or business under section 513(a).
In contrast, if the exempt organization provides substantial services in connection with the exclusive provider arrangement, and the sponsor’s activities are not related to the organization’s tax-exempt purpose, the payment for an exclusive provider arrangement probably would be subject to the UBIT.
Mailing List Rentals

• A tax exempt charitable or educational organization will not be treated as engaged in an unrelated trade or business if it rents or exchanges its mailing lists with another tax exempt charitable or educational organization.

• Most EOs take the position that a mailing list constitutes intangible property and the rental is excludable as a royalty.

• The IRS continues to challenge the EO where non 501(c) (3)s are the purchaser or renter.
Mailing List Rentals

• Suggest that any mailing list agreement should be divided into three separate agreements
  – One for the right to use the name and logo for which a royalty is paid
  – Another for the right to use the mailing list for which a royalty is also paid
  – Third for the marketing or other services that the organization will provide.
Rental Income – Facilities Use

• The use of facilities by the students, faculty, and staff for recreational purposes is related.

• If faculty and staff are permitted to pay a fee that is substantially less than that offered to the general public, the IRS may treat the value of the discount as additional compensation.

• As a general rule, income received from the general public, alumni, spouse and children of students and employees and major university donors (but not always) for the use of facilities are subject to UBI.
Rental Income – Facilities Use

• Likely to be treated by the IRS as subject to UBIT where the institution is providing collateral services such as meals, maintenance, security, laundry, catering, marketing, and other such services not normally provided by a lessor to a lessee

• One of the few times the IRS reads an EO’s exempt purpose broadly – Rev. Rul. 76-33
Summer Sports Camps

• Sole issue is the proper classification under the UBIT statutory scheme

• Only 3 possible choices
  – Pure rental income and excludable modification
  – Performance of services in addition to the rental of property
  – Related to exempt purpose
Summer Sports Camps

• Beware, if the activity is operated by school employees it is likely to be treated as UBI (Rev. Rul. 80-297)

• Leasing of facilities to unrelated person for a fixed fee that is not dependent on the net income is likely exempt under the rental income exclusion

• If the camp is conducted as an educational or charitable activity, it will be treated as related and not subject to UBI
Athletic Events

• Athletic Events typically NOT UBI

• Broadcast revenues also generally NOT UBI

• Other athletic situations MIGHT raise UBI concerns
Fundraising Activities

• Generally not taxed as UBI
• Frequent enough?
• Unrelated to mission?
• Increased IRS attention
• Cause related fundraising, etc
Membership Dues

• Generally NOT classified as UBI
• Generally only in situations where “associate member dues” are collected for participation in various offered programs – health insurance
• Disguised fee for advertising?
• Quid Pro Quo issues?
Child Care

- Child care is not substantially related to the educational purpose of the university.
- Facility is not used as a teaching tool
- Located on a university campus are a “convenience” for university students, faculty, and staff.
- Fees to the general public taxed as UBI
Parking Lots

• Typically strictly UBI per Treasury Regulations

• May be UBI – depending how structured

• Also depending on the purpose for the parking – related event?
Conference Meetings & Training Programs

• Generally NOT subject to UBI if to University groups

• If to outside non-university people – probably still “educational” and not subject to UBI

• Might still have rental exclusion
Relief of Government Burden

• Performance of an essential government activity?
• Previously done by governmental agency?
• Supervised by Government agency?
• Integral part of larger government activity?
• Formal action recognizing University’s involvement?
UBIT

Open forum