Introduction to UBI

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This presentation was developed exclusively for the American Bar Association Heath Law Tax and Accounting Interest Group.

The information provide herein is educational in nature and is based on authorities that are subject to change.
Today’s Presenters

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Key Learning Objectives

- Overview of Unrelated Business Income
- Modifications & Exclusions
- Exceptions
- Examples
- Reporting
Overview Of Unrelated Business Income
Definition of Unrelated Business Income ("UBI")

- **Concept**—net income from an activity that is unrelated to exempt purposes generally is taxable
  - Generates tax revenue
  - Prevents unfair competition

- **Three-part test:**
  - The income-generating activity is a trade or business;
  - The activity is regularly carried on; and
  - The activity is not substantially related to the organization’s purpose.

- *Based on facts and circumstances of each case*
- There are some exceptions that exclude from tax
- Key is how the money is earned, not how it is used
- *Internal Revenue Code ("IRC") §§ 511-514*
- *Modifications and exclusions to UBI are outlined in IRC §§512 and 513*
Definition of Unrelated Business Income (UBI) Continued

Three-part test in Detail:

- **Trade or business**…an activity carried on for the production of income. Profit motive has become an important IRS factor.

- **Regularly carried on**…if the activities exhibit frequency and continuity, and the activities are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

- “**Related” to an organization’s exempt purposes**…if conducting the activities has a causal relationship to and contributes importantly to the achievement of the organization’s exempt purpose (other than simply for the production of income)
  - Depends on the facts and circumstances of each individual case!
Tax Law and Regulations

- IRC §511 imposes a tax on the unrelated business taxable income of organizations described in IRC §§ 401(a) and 501(c).

- IRC §512(a)(1) defines the term “unrelated business taxable income” as gross income derived by an organization from any unrelated trade or business regularly carried on by it, less directly-connected deductions.

- IRC §513(a) defines the term “unrelated trade or business” as any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption.
Tax Law and Regulations Continued

• Treas. Reg. 1.513-1(d)(1) – must examine the relationship between the business activities which generate the particular income in question and the accomplishment of the organization's exempt purposes.

• Treas. Reg. 1.513-1(d)(2) – a trade or business is related to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of any exempt purpose:
  • Causal relationship must be substantial; and
  • The activity must contribute importantly to the accomplishment of those purposes.
  
  ❖ The focus is how income is generated, not how it is used.
Analysis – Facts and Circumstances

• Facts and circumstances analysis.

• Read background documents (such as contracts).

• Discuss with client (cannot rely solely on email communications).

• Independent research of facts and circumstances, if needed, to fully understand the situation.
Analysis – Exempt Purpose

• In order to determine whether an activity is related to your exempt purpose, you must know your exempt purpose!

• Some potential challenges:
  • Outdated Articles of Incorporation
  • Purpose clause stated too narrow (such as “operate a hospital”)
  • Purpose clause stated too broad (organized for “charitable, scientific, and educational purposes”)
  • Purpose clauses in Articles of Incorporation and Bylaws have diverged over the years

• It is a good idea to periodically review the organization’s purpose clause to ascertain whether it is accurate and up-to-date.

• Does the activities of the organization align with the mission statement?
Modifications & Exclusions
Common Modifications from UBI

MODIFICATIONS

• Passive investment income;
• Royalties;
• Gain/loss from sale, exchange, or disposition of property;
• Research Income; and
• Real property rental income.
• Exceptions: Stay tuned…

† IRC § 512(b)(4): To the extent there is debt-financed property with “acquisition indebtedness” the exceptions generally do not apply.
Common Exclusions from UBI

EXCLUSIONS:

• Volunteer labor exception;
• Convenience exception;
• Donated merchandise; and
• Small hospitals.

• Substantially all the activity is carried on by volunteers. Known as the “volunteer exception.”

• The activity is carried on primarily for the convenience of its members, students, patients, officers, or employees. Known as the “convenience exception.”
Exceptions to the Exceptions
Rental Income & Debt Financed Income

• Generally, rental income from Real Property may be excluded.

• Rental income from real property generally UBI where:
  • Amount of rent is calculated as a percentage of the tenant’s net income;
  • Payment includes compensation for services (for example, security guards) rendered to tenant; and
  • Ask Yourself: Are Services being Provided?
• More than 50% of rent is attributable to personal property leased with real property.

<table>
<thead>
<tr>
<th>Amount of rent attributable to personal property</th>
<th>Amount of rent considered UBI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 10%</td>
<td>No UBI</td>
</tr>
<tr>
<td>Between 10% - 50%</td>
<td>Pro-rata share is UBI</td>
</tr>
<tr>
<td>Greater than 50%</td>
<td>100% is UBI</td>
</tr>
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</table>

• Debt-financed property*
IRC §514 – Unrelated Debt Financed Income

• IRC §514
  • (a)(1) – Income generated from debt financed property is subject to UBI tax under a ratio of the average acquisition indebtedness for the taxable year with respect to the property over the average adjusted basis of the debt financed property.
  • (a)(2) – Deductions directly connected to the debt financed property are allowed equal to the percentage determined above in paragraph (1).
  • Depreciation deductions must be calculated using the straight line method.

• Exception from the definition of debt financed property if the use of the property is “substantially” (85%) related to the organization’s exempt purpose.

• IRC §514(c)(2)

• Property acquired subject to a mortgage.
  • Acquired by a bequest or devise. Not considered acquisition indebtedness for a period of 10 years.
  • Acquired by a gift. Not considered acquisition indebtedness for a period of 10 years if (1) the mortgage was placed on the property more than 5 years before the gift and (2) the property was held by the donor more than 5 years before the gift.
Income from Controlled Organizations

• IRC §512(b)(13).

• Generally treats otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a controlled subsidiary.

• The purpose of the rule is to prevent a tax-exempt organization from inappropriately sharing the benefits of its tax-exempt status with taxable entities.

• Exclusion available under IRC §§512(b)(13)(E)(i) and 482.
Common Examples
Common UBI Examples: Pass-Through Entities

- **Partnership Investments**
  - Partnership flow through items retain interest/character for UBI purposes
  - If partnership generates UBI, organization’s distributive share is taxable
  - In calculating the total UBI from an investment in a partnership, the tax-exempt organization may be able to exclude specific income items from its total UBI

- **S-Corporation Investments**
  - Entire share of S corporation income is UBI

- **Alternative Investments**
  - Partnership is required to furnish any UBI on its K-1 to the partner
  - May be reported in box 20V or in footnotes
  - If an exempt organization’s tax year differs from the partnership’s, report share of income/deductions for partnership’s tax year ending with or within the exempt organization’s tax year
IRS Revenue Ruling 98-15

• Ancillary healthcare joint ventures between a tax-exempt and taxable entity.

• This Ruling primarily addressed Exemption.

• The tax-exempt entity must control the joint venture or UBI.

• IRS defines control as either of the following:
  • The tax-exempt entity owns at least 51% of the joint venture.

• The joint venture operating agreement contains safeguards which ensure the joint venture will be operated in a manner that furthers the tax-exempt charitable purposes of the tax-exempt entity.
Case Law Examples

What about Organizations formed to provide management/ancillary services to exempt entities?

• Ask yourself: Are the Organizations Related or Unrelated entities?

Provision of administrative services to unrelated parties:

• Revenue Ruling 72-369, 1972-2 C.B. 245 – an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations does not qualify for exemption.

• Revenue Ruling 78-41, 1978-1 C.B. 148 – a trust, the sole purpose of which was to accumulate and hold funds for use in satisfying malpractice claims against a hospital, was an integral part of the hospital because it was controlled by the hospital and because it was performing a function that the hospital could do directly, and thus qualified for exemption.

• PLR 201315027 – the IRS denied exemption to a nonprofit organization that was formed for the purpose of providing administrative, management and other supportive services to unrelated tax-exempt organizations.
Common UBI Examples: Laboratory Services & Pharmacy Sales

- As a general rule, IRS uses a patient vs. non-patient approach to determining taxability of laboratory services and sales of pharmaceuticals
  - Sales to patients = related/excluded
  - Sales to non-patients = unrelated

- A patient is (Revenue Ruling 68-376):
  - A person admitted to the hospital as an inpatient
  - A person receiving general or emergency diagnostic, therapeutic or preventative health services from the hospital’s outpatient facilities
  - A person referred directly to the hospital’s outpatient facilities by his/her private physician for specific diagnostic or treatment procedures
  - A person refilling a prescription written during the course of his/her treatment as a patient of the hospital
  - A person receiving medical services as part of a hospital-administered home care program
  - A person receiving medical care and services in a hospital-affiliated extended care facility

- Private patients of hospital staff physicians are not patients
Common UBI Examples: St. Luke’s Hospital Case

- **St. Luke’s Hospital of Kansas City v. United States**

- **Background of the Case**
  - Program was significantly related to hospital’s tax-exempt purpose;
  - Tests contributed to teaching function of hospital by providing large number of specimens necessary for study; and
  - Small size of the program and insignificant revenues generated showed it was non-commercial operation.

- **Common in Academic Medical Centers**
  - Rev. Rul. 85-109
  - Rev. Rul. 85-110
  - PLR 9739043
Common UBI Examples: Fitness Center

**Excluded/Related:**
- UBI does not include income from a trade or business primarily for the convenience of its members.
- The recreation or athletic facility is substantially related to and has a causal relationship to the achievement of the organization’s exempt purpose.
- Promotion of Health.
- Location on health center or campus becomes an important deciding factor.

**Unrelated:**
- The recreation or athletic facility does not have a causal relationship to the achievement of a hospital’s exempt purposes and is not used solely by patients or staff.
- Recreation or athletic facility used primarily by the general public; resembles that of a commercial fitness club, charges high/competitive rates.
Common UBI Examples: Advertising

- Sale of advertising in a publication or other media published by exempt organizations is considered an unrelated trade or business.

- Advertising in a publication circulated to members “exploits” the exempt function of the organization.

- Profits generated from advertising activities may be reduced (not less than zero) by the amount which “readership costs” exceed “circulation income”.
  - Readership costs: the cost of producing and distributing the exempt activity readership content
  - Circulation income: the subscription income and/or portion of dues attributable to receiving the periodical

- **ISSUE:** Distinguishing advertising from an acknowledgment/corporate sponsorship…
Common UBI Examples: Hospital Gift Shops

**Gift Shop**: Gift shop patronized by hospital employees, patients, and visitors making purchases for patients that sells candy, newspapers, reading material, flowers and other small gift items, and operates a gift cart taken throughout the hospital enables the hospital to keep its employees on the premises, and improves the comfort of its patients – NOT UBI (Rev. Rule 69-267)
Common UBI Examples: Parking Lot/Facilities Operations

• Are Parking Garage Activities considered UBI?
  • IT DEPENDS!!!

• Possible Exemptions to Analyze:
  • Convenience for patients?
  • Substantially Related to Exempt Function?
  • Charitable Activity?
  • Not Regularly Carried on Exemption?
  • Volunteer Services Exemption?
  • Rental Income Exemption?

❖ Remember, gather facts, review contracts, ask questions.
Reporting
Federal Reporting

- Federal Form 990-T filing requirement if a tax-exempt organization has more than $1,000 of Gross UBI.

- Approach – 3 Step Analysis:
  - Characterization of Income/Activities;
  - Expense Allocations; and
  - Net Operating Loss Analysis.

- Federal Form 990.
Federal Reporting Continued

- **Expense Allocations**
  - Ordinary and necessary business expenses
  - Proximate and primary relationship to the revenue
  - Direct vs. indirect costs
  - Net operating losses year over year

- **Other Deductions/Credits**
  - “Corporate” concepts apply

- **Alternative Minimum Tax**

- **Planning of Charitable Contributions & NOLs**

- **Estimated Tax Payments**
Federal Reporting Continued

IRS Key Focus Areas of IRS EO Exams

• Exemption
• Protection of Assets
• **Tax Gap**
• International
• Emerging issues
State Reporting & Issues
State UBI & Reporting

• Issue: No general rule that applies in every state and city.

• Sometimes the state or local rules parallel the federal statues; and in others they are completely different.

• Most state confirm in whole or in part to the federal definition of Unrelated Business Taxable Income (“UBTI”) as defined under §512(a)(1).

• 40 out of the 50 states tax UBI
### State UBI & Reporting Continued

<table>
<thead>
<tr>
<th>Description</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of states that tax unrelated business income</td>
<td>40</td>
</tr>
<tr>
<td>Number of states with distinct Form 990-T</td>
<td>13</td>
</tr>
<tr>
<td>Approximate # of states minimum tax penalty (range $10 to $500)</td>
<td>12</td>
</tr>
<tr>
<td>Number of states with UBTI minimum threshold</td>
<td>9</td>
</tr>
<tr>
<td>Number of states with “reportable transaction” disclosures</td>
<td>11</td>
</tr>
<tr>
<td>Number of states that allow allocation vs. apportionment – GA, HI, IL, MA, NY</td>
<td>5</td>
</tr>
</tbody>
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Stay alert! 1) State filing requirements subject to change

2) Increased state audit activity

3) States requiring tax withholding behalf of partners

4) Refer to state instructions – a few exempt 401(a) trusts
State Process Considerations:

- Deciding
  - Filing threshold
  - How many years to file
  - Methods

- After first state filing
  - NOL availability
  - Dealing with notices
  - Extensions, and
  - Estimated payments

- Other potential consequences of state income tax filing
  - State registration (DOR and/or SOS)
  - Charitable solicitation registration

- Hours and volume involved
  - Staff and/or budget to handle
Questions & Closing
Questions?
Thank you!

For more information, please contact:

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You should contact your tax advisor regarding application of the information provided to your specific facts and circumstances.