Unrelated Business Income: Practical Tips & Tricky Issues

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CPAs & Advisors

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OUR GOALS FOR TODAY

1. What is Unrelated Business Income (UBI) and what is it not?
2. How to identify potential UBI
3. If you have UBI, what's next?

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OUR GOALS FOR TODAY

4 Changes from Tax Cuts and Jobs Act

5 Questions

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Acronyms

- UBI – Unrelated business income
- UBIT – Unrelated business income tax
- UBTI – Unrelated business taxable income

What Is Unrelated Business Income?

- Unrelated Business Income (UBI) is the income from a trade or business regularly conducted by an exempt organization and not substantially related to its exempt purpose.
- UBI Criteria:
  - Activity must be a trade or business,
  - Activity must be regularly carried on, and
  - Activity is not substantially related to the organization's exempt purposes.
- All three criteria must be met for an activity to generate UBI.

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NOT SUBSTANTIALLY RELATED

- An activity will be related only if there is a “casual relationship” between it and the organization’s exempt purposes and will be substantially related only if the casual relationship is a substantial one and “contributes importantly” to the conduct of the organization’s exempt purpose.
- Principles in determining substantially related
  - Selling of products from exempt functions is not UBI
    - Unless used beyond what is necessary to dispose of
  - Dual use of assets or facilities
    - The activity, not the facility, is the determining factor
  - Exploitation of exempt functions
    - Advertising sales

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Activities Excluded From UBI

- Volunteer workforce
  - Substantially all (at least 85%) without compensation
- Convenience of members
  - 501(c)(3) organizations
  - Members, students, patients, officers or employees
- Selling donated merchandise
  - Substantially all (at least 85%) received as contributions
- Exchange or rental of members lists between organizations eligible to receive charitable contributions

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Activities Excluded From UBI (*Continued)*

- Bingo games
  - Meets legal definition of gambling
  - It is legal where it is played
  - It is played in a jurisdiction where bingo games are not regularly conducted by for-profit organizations
- Convention, trade show or annual meeting activity
  - 501(c)(3), (4), (5) or (6) organizations

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Activities Excluded From UBI (*Continued)*

- Distribution of low-cost articles
  - Only organizations eligible to receive charitable contributions
  - The recipient did not request the distribution
  - The article is accompanied by a request for a charitable contribution and a statement that the recipient may keep the article regardless of whether a contribution is made
  - The cost is not more than $5 indexed annually ($11.10 in 2019)

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Activities Excluded From UBI (*Continued)*

- Qualified sponsorship payments
  - No substantial benefit other than use or acknowledgment of business name, logo or product lines
  - Providing facilities, services or other privileges, e.g. complimentary tickets, receptions, is treated as a separate transaction for UBI analysis
  - Part of payment that is for advertising is treated as a separate transaction for UBI analysis

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Income Excluded From UBI

- Dividends, interest, annuities and other investment income
  - Not excluded if received from controlled entity
  - Not excluded if debt-financed
  - Not excluded if from S Corporation
  - Not excluded if a 501(c)(7), (9), (17) or (20) organization
- Royalties
  - Not excluded if received from controlled entity
  - Not excluded if debt-financed

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Income Excluded From UBI (*Continued*)

- Rents
  - Not excluded if based on net profit
  - Mixed leases
    - If personal property is between >10% and <50% real property lease is excluded
    - If personal property >50% none are excludable
  - If personal services are rendered not excludable
  - Not excluded if received from controlled entity
  - Not excluded if debt-financed

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Income Excluded From UBI (*Continued*)

- Research
  - Depends on nature of organization and type of research
- Gains and losses from disposition of property
  - Not for debt-financed property

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Debt-financed Property

- Acquisition indebtedness is the unpaid amount of debt incurred
  - When acquiring or improving the property
  - Before acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement
  - After acquiring or improving the property if the debt would not have been incurred except for the acquisition or improvement ***and*** incurring the debt was reasonably foreseeable when the property was acquired or improved

Acquisition Indebtedness

- Debt that is not acquisition indebtedness
  - Debt incurred in performing exempt purpose
  - Annuity obligation
  - Security loans
    - Unless used to buy those securities

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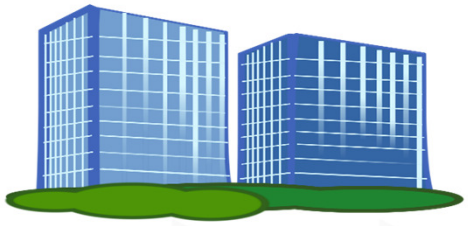
Exceptions To Debt-financed Property

- Property related to exempt purposes – 85% or more
- Property used in research activities
- Property used by related exempt organization to further exempt purpose
- Leased to a medical clinic primarily for purposes related to lessor's performance of its exempt purpose



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How Do You Identify Potential UBI?

- Identify income from activities – consider these
  - Charge for use of parking lot during special events?
  - Sell advertising in a publication, newsletter, program, website, or other media?
  - Operate a gift shop, bookstore, or restaurant?
  - Rent property to others?
  - Have ownership in a joint venture; i.e. partnership, S-Corp, etc.?
  - Conduct games of chance?
  - License use of name, logo, or mailing list?
  - Provide management or administrative services for a fee?
  - Provide lab services or pharmacy services to non-patients?

Analyze Income From Activities

Is the activity regularly carried on?

- No – no UBI
- Yes – continue analysis

Is the activity related to the exempt purpose?

- Yes – no UBI
- No – continue analysis

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Analyze Income From Activities

Does the activity lack a profit motive (i.e. continue for reason other than producing net income)?

- Yes – no UBI. Document why no profit motive. Consider reporting income on 990T with expenses equal to income.
- No – continue analysis

Does the activity qualify for an exclusion such as the volunteer labor, convenience or donated items?

- Yes – no UBI. Document the exclusion.
- No – continue analysis

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Analyze Income From Activities

For sponsorship payments, are there any benefits other than use or acknowledgment of business name, logo or product lines?

- No – no UBI.
- Yes – continue analysis for other benefits

Is the income over $1,000

- No – no 990T required.
- Yes – continue analysis, probably have reportable UBI

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Identify Potential UBI Sources

- Does the organization
  - Own stock in a S corporation?
    - UBI
  - Own an interest in a partnership?
    - Line 20V should disclose UBI
    - Consider whether line 1 ordinary income would be UBI even if line 20V is blank
    - Read the entire K-1, often the information on UBI is disclosed in a footnote but not on page 1 of the K-1 or listed under code 20V

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Identify Potential UBI Sources - Continued

- Receive any income (other than dividends) from an organization in which it has more than 50% ownership interest whether direct or indirect (controlled corporation)?
  - Subject to tax whether or not conducted as a trade or business or regularly carried on
  - Specified payment is payment (received or accrued) of interest, annuities, royalties or rents
  - Included in UBI to the extent it reduces net unrelated income (or increases net unrelated loss) of the controlled organization
  - Qualifying specified payment received after December 31, 2005, & before January 1, 2014, pursuant to binding written contract in effect on August 17, 2006, subject to tax only on amount in excess of amount computed under Section 482

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Identify Potential UBI Sources - Continued

- Receive income generated by assets financed with debt?
  - Rental property and securities acquired on the margin are the most common examples
  - Ratio of average basis of property during year to average debt during the year, not to exceed 100%, determines the allocation of income and deductions
  - Straight-line method of depreciation must be used

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UBI Has Been Identified, What's Next?

- Determine expenses directly connected
- Determine any other allowed expenses
- Specific deduction of $1,000
- Compute federal tax and credits
- Maintain 990-T for public disclosure
- Consider state apportionments and state filings
- Controlled group

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Changes from Tax Cuts and Jobs Act

- UBI siloing
- New corporate tax rates
- Net operating loss carryovers
- Schedule M

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Unrelated Business Income Siloing

- The loss from one business activity can no longer be used to offset the gain from another
- In other words, the sum of all unrelated business activities can't be less than $0
- IRS Guidance – Issued Final Regulations under Section 512(a)(6)

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Guidance on Siloing

Final Regulations provide:

- Exempt organization with more than one unrelated trade of business must compute UBTI separately with respect to each unrelated trade or business, without regard to the $1K specific deduction, including determining any NOL deduction
- NAICS codes - first two digits
- Review unrelated business activities by NAICS codes and determine methodology for allocating the expenses

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UBI Generated from Partnerships

- If partnership interest meets certain criteria under the de minimis test or the significant participation test, the UBI can be aggregated as investment activities versus breaking out the income into various business lines or activities
- De minimis test - applicable if the institution doesn’t directly or indirectly hold more than 2% of a profit or capital interest in the partnership
- Significant Participation test (formerly Control Test) - applicable if the institution doesn’t directly or indirectly hold more than 20% of a capital interest & doesn’t have control or influence over the partnership based on facts and circumstances

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Flat Corporate Rate

- New flat corporate rate of 21% and the repeal of the alternative minimum tax.
  - For fiscal year filers, the fiscal year containing January 1, 2018, used a blended rate between the old marginal rates & the new 21% flat rate
- Will the political transitions in 2021 affect future rates?

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Net Operating Losses

- Net operating losses incurred before 2018 tax years can be used to offset UBI from any activity
  - These net operating losses can be carried forward 20 years
  - Will use these net operating losses first
- Net operating losses incurred after 2018 tax years, need to be tracked separately by activity, but carry forward indefinitely

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Schedule M

- New Schedule M created to report more than one UBI activity
- Looks like page 1 of the Form 990-T
- Requires separate attachments to support each additional Schedule M

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Questions?

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Thank You!

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